Parliamentary Joint Committee on Corporations and Financial Services

Statutory Oversight of the Australian Securities and Investments Commission: the role of gatekeepers in Australia's financial services system

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Duties of the Committee

Section 243 of the *Australian Securities and Investments Commission Act 2001* sets out the Parliamentary Committee's duties as follows:

(a) to inquire into, and report to both Houses on:

(i) activities of ASIC or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or

(ii) the operation of the corporations legislation (other than the excluded provisions), or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); and

(b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and

(c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

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Abbreviations

ACSA	Australian Custodial Services Association
AFSL	Australian Financial Services Licence
AIST	Australian Institute for Superannuation Trustees
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
ATO	Australian Taxation Office
AUASB	Auditing and Assurance Standards Board
FOFA	Future of Financial Advice
FPA	Financial Planning Association
FSC	Financial Services Council
IIRC	International Integrated Reporting Council
IR	Integrated reporting
MIS	Managed investment schemes
NTA	Net tangible asset
PJC	Parliamentary Joint Committee
REs	Responsible entities
RG	Regulatory Guide
RSEs	Registrable superannuation entities
SMSF	Self-managed superannuation fund
UK	United Kingdom
US	United States

Chapter 1

Introduction

1.1 The Parliamentary Joint Committee on Corporations and Financial Services was established by the *Australian Securities and Investments Commission Act 2001* (the ASIC Act). Section 243 of the ASIC Act specifies the committee's duties, which include:

> (a) to inquire into, and to report to both Houses on:
>
> the activities of the Australian Securities and Investments Commission (ASIC)…or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed…

1.2 This report is presented in execution of the committee's duty under paragraph 243(a)(i).

1.3 As the corporate, markets and financial services regulator, the Australian Securities and Investments Commission (ASIC) is responsible for monitoring the integrity of Australia's financial system. Areas within the Commission's remit include promoting financial literacy and consumer education; corporate, financial services and consumer credit regulation; and the supervision of trading on Australia's licensed equity derivatives and futures market.

1.4 In inquiring into ASIC's activities, the committee seeks to determine whether ASIC is fulfilling its statutory responsibilities. In considering ASIC's performance, the committee has regard to section 1 of the ASIC Act, which directs ASIC to:

- maintain, facilitate and improve the performance of the financial system and entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy;
- promote the confident and informed participation of investors and consumers in the financial system;
- administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements;
- receive, process and store, efficiently and quickly, information given to ASIC under the laws that confer functions and powers on it;
- ensure that information is available as soon as practicable for access by the public; and
- take all necessary action to enforce and give effect to the laws of the Commonwealth that confer functions and powers on it.

The public hearing

1.5 The committee held a public hearing on 21 June 2013 at the New South Wales State Library in Sydney. The hearing took the form of a roundtable comprising representatives from the key gatekeepers in Australia's financial services system: financial planners and financial advisers, research houses, custodians, trustees, responsible entities (REs) and auditors.

1.6 The roundtable was designed to examine some of the issues that were raised in chapter 7 of the committee's report into Trio Capital, and in particular the expectation gaps between what investors and the public expects gatekeepers and regulators to achieve, what is legally required of them, and what their roles involve in practice.[1] The committee was also interested not only in how the gatekeepers saw their own role and responsibilities, but in how they perceived the roles of other gatekeepers in the financial system.

1.7 At the roundtable, the committee took evidence from two gatekeepers representing each of Australia's financial services sectors: research houses, financial planners and financial advisers, custodians, trustees, REs, and auditors.

- Mr Richard Everingham, General Manager—Strategy and Development, Lonsec Research Pty Ltd;
- Mr Mark Thomas, Chief Executive Officer, van Eyk Research Pty Ltd;
- Ms Nerida Cole, Managing Director, Dixon Advisory;
- Mr Tony Graham, Executive Director, Macquarie Group Limited;
- Mr Pierre Jond, Chairman, Australian Custodial Services Association;
- Mr Paul Khoury, Deputy Chairman, Australian Custodial Services Association;
- Ms Karen Volpato, Senior Policy Adviser, Australian Institute of Superannuation Trustees;
- Mr Martin Codina, Director of Policy & International Markets, Financial Services Council;
- Ms Eve Brown, Senior Policy Manager—Trustees, Financial Services Council;
- Mr Royce Brennan, General Manager—Risk, BT Financial Group;
- Mr Justin Epstein, Executive Director, One Investment Group;
- Mr Graeme McKenzie, Partner, Ernst & Young;

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1 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, pp 123–124, http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/completed_inquiries/2010-13/trio/report/index.htm (accessed 12 June 2013).

- Mr Tony Smith, Partner, Ernst & Young; and
- Mr Amir Ghandar, Policy Adviser—Audit & Assurance, CPA Australia (see Appendix 1).

1.8 The committee selected two representatives from each sector in order to gain the views of gatekeepers that operated a diversity of business models. For example:

- Lonsec Research and van Eyk Research fund their research via markedly different business models;
- Dixon Advisory operates as a financial advisory business whereas Macquarie Group operates at many levels as a provider of banking services, financial products, and financial advisory services; and
- One Investment Group operates as an external RE whereas BT Financial Group, amongst other services, operates internal RE services.

1.9 A brief overview of each of the gatekeeper businesses and industry organisations is given in Appendix 1. The different business models are covered in greater detail in chapter 2.

1.10 Following the roundtable, the committee took evidence from ASIC officials, including the ASIC Deputy Chairman, Mr Peter Kell. For the purposes of this report, it is important to note that the issues raised at the roundtable were not part of the discussion with the officials from ASIC. Several written questions that had relevance to the roundtable discussion were placed on notice for ASIC. ASIC's responses are incorporated into chapters 3, 4 and 5 of this report.

1.11 This report principally reflects the verbal evidence and written statements of roundtable participants. Copies of the Hansard transcript of the hearing have been tabled for the information of the Parliament, and are available on the committee's website.[2] The written statements are also available on the committee's website. Questions placed on notice, and the answers received, are published on the committee's website. The answers from ASIC and one answer from BT Financial Group regarding the merits of active asset management are included in Appendix 2.

1.12 The committee thanks all those who gave evidence for their time and their contribution to the inquiry.

Key issues and the structure of the report

1.13 This report deals with the key issues arising from the roundtable discussion with financial system gatekeepers, and includes ASIC's response to these issues.

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2 Parliamentary Joint Committee on Corporations and Financial Services, *Oversight of ASIC*, http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/asic/index.htm (accessed 2 April 2013).

1.14 Chapter 2 looks at the financial system gatekeeper framework in Australia and provides background on research houses, financial planners and financial advisers, custodians, trustees, REs and fund managers, and auditors. The chapter covers the relevant gatekeeper business models and potential conflicts of interest.

1.15 Chapter 3 presents the evidence from the roundtable discussion with particular focus on the relationships between research houses, fund managers, and financial planners and financial advisers.

1.16 Chapter 4 presents the evidence from the roundtable discussion with particular focus on the interactions between custodians, trustees, REs, and the auditors of REs and the auditors of registrable superannuation entities. This discussion also covers key issues such as the responsibility for asset valuation, asset disclosure, and asset verification.

1.17 Chapter 5 presents the discussion of other issues arising at the roundtable including the regulation and oversight of self managed superannuation funds, integrated reporting, the detection of fraud, the challenges of new communications technology, the merits and drawbacks of passive index funds versus active asset management, and the balance between market efficiency and investor protection.

Chapter 2

The gatekeeper framework in Australia

Background

2.1 The roundtable with financial system gatekeepers was convened to examine expectation gaps in Australia's financial services system and to discuss the steps that are being taken to deal with those gaps.

2.2 Gatekeepers play a crucial role in the functioning of the financial services system. While the Australian Securities and Investments Commission (ASIC) sets the regulatory standards for the gatekeepers and expectations of their performance, the system is 'self-executing'. As ASIC Chairman, Mr Greg Medcraft, told the committee in September last year:

> ASIC is not a prudential regulator, not a conduct and surveillance regulator. The system we have is based on gatekeepers doing the right thing and it is self-executing. It is quite important in understanding what we are currently resourced to do. We are not resourced to be looking at everybody, and that is a very important message.[1]

2.3 Gatekeepers such as the research house, Lonsec Research Property Ltd, acknowledged that the financial services system has historically been lightly regulated. Lonsec observed that the regulator has outsourced significant elements of the gatekeeper function to the private sector, and that ASIC's role is to hold the gatekeepers to account.[2]

2.4 The problem of 'expectation gaps' was raised by ASIC at the inquiry held by the Parliamentary Joint Committee on Corporations and Financial Services (the committee) into the collapse of Trio Capital Limited (Trio). ASIC's submission to the inquiry pointed to potential expectation gaps between the role of gatekeepers in Australia's financial services system and investors' expectations of that role.[3]

2.5 Chapter 7 of the committee's report into Trio canvassed a series of expectations gaps between what investors and the public expected the gatekeepers to

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1 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 12 September 2012, p. 15.

2 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [3].

3 Australian Securities and Investments Commission, *Submission 51*, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012, http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/completed_inquiries/2010-13/trio/submissions.htm (accessed 2 July 2013).

achieve, what gatekeepers were legally required to do, and what their roles involved in practice:

- first, and most significantly, most Trio investors in self-managed superannuation funds (SMSFs) seemed not to be aware that their investment was not protected to the same extent as investments made in Australian Prudential Regulation Authority (APRA) regulated superannuation funds. This has been a clear and recurring theme during this inquiry and is of particular concern to the committee;
- second and related, there is an expectation among investors that financial advisers will check the investments that they recommend to their clients, to ensure not only that there are prospects for good returns but that they are run legitimately;
- third, there is a lack of understanding as to how Australian Financial Services Licences (AFSLs) are issued. The AFSL attaches to the company, not the directors;
- fourth, both the regulators and investors have expressed frustration at the role of Trio Capital's financial statement and compliance plan auditors, particularly their inability to verify information. The auditors cite the limitations on their role and that the primary responsibility for detecting fraud rests with the responsible entity (RE). They note that auditors can only obtain reasonable assurance that a financial report is free from material misstatement, whether caused by fraud or error;
- fifth, there is an expectation in the public mind that custodians will act to protect and secure the underlying investment. By contrast, Trio's custodian, the National Australia Trustee Limited, has noted that the custodian does not have the expertise to question underlying values of either domestic or offshore funds;
- sixth, there is a lack of understanding as to the claims made in the reports issued by research houses and in particular, whether the data provided by the RE upon which these reports are based has been verified. There is also some confusion as to whether the ratings are intended as an indicator of future performance, or simply an assessment of past performance; and
- finally, ASIC has noted that, compared to the United States and Europe, the level of underlying portfolio disclosure of managed investment schemes in Australia is very limited. Both ASIC and Morningstar have suggested there should be disclosure at asset level for registered managed investment schemes to help investors assess both the type of financial products they are exposed to, and the extent of that exposure.[4]

2.6 In March 2013, at its Annual Forum, ASIC convened a session titled 'Bridging the gap'. The session examined expectation gaps and how gatekeepers try to deal with them.[5]

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4 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, pp 123–124, http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/completed_inquiries/2010-13/trio/report/index.htm (accessed 12 June 2013).

5 Australian Securities and Investments Commission, 'Bridging the gap', *Annual Forum 2013—The New Normal*, 25–26 March 2013, Hilton, Sydney NSW, http://www.asic.gov.au/annual-forum (accessed 3 June 2013).

2.7 The committee wanted to examine these issues in more detail by taking a holistic or system-wide view. At the roundtable, the interest was not only in how the gatekeepers saw their own roles and responsibilities, but in how they perceived each other's roles. In other words, in addition to examining gaps that might exist between investor expectations and gatekeeper roles, the committee wanted to see whether there were gaps in the system, with confusion or misunderstanding by one group of gatekeepers about the role of another group.

2.8 Following the roundtable, the committee placed a series of written questions on notice to ASIC based on the discussion with the gatekeepers. These responses are presented in Appendix 2.

The gatekeepers

2.9 The key gatekeepers in the financial services system—financial planners and financial advisers, custodians, research houses, auditors, trustees, and REs—are regulated by ASIC. In the wake of the Trio fraud and other corporate collapses, ASIC has focused on the roles and standards of these groups. The roundtable also gave the committee an opportunity to engage with the gatekeepers and ASIC on the consultations and regulatory changes since Trio.

2.10 Some gatekeepers are dual-regulated entities. For example, of the 500-plus REs operating in Australia in 2012, 33 held both an AFSL from ASIC to operate as an RE, and a registrable superannuation entity (RSE) licence from the Australian Prudential Regulation Authority (APRA) to operate as an RSE.[6]

2.11 Trio was a dual-regulated entity. It provided RSE trustee services for a series of APRA-regulated superannuation schemes and RE services for more than 20 managed investment schemes (MISs).

2.12 Directors also function as vital gatekeepers in the Australian financial services system. Although the committee did not specifically invite directors as a distinct group, the panel did include gatekeeper representatives that acted as managing directors, as director and chief executive officer, and as executive directors in their respective businesses.

2.13 The following sections provide background information on the different gatekeepers, noting what they do and their different structures and business models.

2.14 The gatekeepers are discussed in the following order:

- research houses and research report providers;
- financial planners and financial advisers;

6 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 11.

- custodians;
- REs and fund managers;
- trustees; and
- auditors.

Research houses and research report providers

2.15 Research report providers include research houses. The terms research house and research report provider have both been used by government agencies when referring to the research report industry. In November 2008, Treasury and ASIC released a joint report on credit rating agencies and research houses,[7] while ASIC's most recent regulatory guidance is targeted at research report providers.[8] For ease of use, and given that the committee invited two research houses to participate in the roundtable, this report refers to the providers of investment research as research houses. However, this designation comes with an important proviso, and that is that some research is also produced internally by other entities within the financial services sector such as advisory groups and fund managers.

2.16 Research houses produce investment research on financial products such as managed funds, structured products, superannuation funds and insurance products.[9] A research report typically provides an express or implicit opinion and a rating (except a credit rating) about an investment product, and a recommendation to buy, sell or hold the product.[10]

2.17 Wholesale users such as financial planners and financial advisers are the main users of research reports. In other words, the main target group for research houses are the financial intermediaries in the system. Financial advice businesses construct an approved product list based on research reports for use by their authorised

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7 The Treasury and the Australian Securities and Investments Commission, *Review of credit rating agencies and research houses*, Joint Report, No. 143, October 2008. http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep143.pdf/$file/rep143.pdf (accessed 12 June 2013).

8 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg79-published-10-December-2012.pdf/$file/rg79-published-10-December-2012.pdf (accessed 12 June 2013).

9 The Treasury and the Australian Securities and Investments Commission, *Review of credit rating agencies and research houses*, Joint Report, No. 143, October 2008, p. 23.

10 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 9.

representatives. However, some research houses also offer subscriptions to their reports on superannuation products to retail clients.[11]

2.18 Given that research reports are used by both financial planners and financial advisers (and some retail clients), the quality of investment research has a direct bearing on the quality of advice that retail investors receive. ASIC has underscored the importance of improving the quality of research reports by noting that positive research reports have been given to products just prior to their failure:

> In a number of recent corporate collapses in Australia, the investment products that failed were either highly rated or the subject of very recent positive recommendations by research report providers just before the product failure.[12]

2.19 In addition to poor quality investment research, ASIC also noted other issues of concern including a lack of due diligence and an over-reliance on research reports by financial intermediaries, and a lack of awareness about the potential compromises involved in the reports themselves:

> Risks for the investment community are amplified where there is undue reliance on research reports and a lack of awareness of real and potential conflicts of interest which may adversely impact on the independence and therefore the reliability of those reports.[13]

2.20 The various conflicts of interest associated with the business models adopted by Australian research houses are explained in the next section.

Australian research houses: business models and conflicts of interest

2.21 There are five major research houses currently operating in Australia: Lonsec, Mercer, Morningstar, van Eyk and Zenith. Mercer and Morningstar are the only two global businesses in the Australian research market.

2.22 The research houses use different business models to fund their research and rely on various combinations of the following:

- subscription fees from end-users such as financial planners and advisers ('downstream' payments);

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11 The Treasury and the Australian Securities and Investments Commission, *Review of credit rating agencies and research houses*, Joint Report, No. 143, October 2008, p. 24; Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 4.

12 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 4, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg79-published-10-December-2012.pdf/$file/rg79-published-10-December-2012.pdf (accessed 12 June 2013).

13 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 5.

- direct payments from fund managers who offer and may have designed the financial product ('upstream' payments); and
- indirect payments from fund managers ('upstream payments').

2.23 Direct payments from fund managers have raised concerns because of the inherent conflicts of interest that arise when a research house assesses a fund manager's product and accepts a fee from the fund manager for that assessment.

2.24 'Downstream' payments from independent financial planners and advisers have not raised the same concerns because they avoid these conflicts. However, less obvious conflicts may still arise when a research house based on a 'downstream' subscription model does accept indirect payments from fund managers.

2.25 In 2012, Fairfax journalist Ruth Williams listed some examples of indirect payments to research houses:

- the licence fees charged by Morningstar when fund managers use the Morningstar logo and ratings on promotional materials;
- payments from fund managers to advertise in van Eyk's twice-yearly magazine;
- payments from fund managers to advertise in Morningstar's *Investor Daily* online newsletter;
- sponsorship from fund managers for Morningstar's Investment Conference;
- payments from fund managers to attend Mercer forums;
- payments by funds to be listed in Morningstar's industry database; and
- van Eyk's partnership with Advisor Edge, which does accept fees from product issuers.[14]

2.26 Lonsec and Zenith accept payments from fund managers to conduct research into products. Mercer, Morningstar and van Eyk do not accept these payments and instead use a subscriber-based business model where financial planning and advisory firms purchase the research. However, Mercer, Morningstar and van Eyk do accept some forms of indirect payments from fund managers.

2.27 There has been debate in the industry about the number of research houses in the Australian market. These views have been canvassed in the publication *Money Management*, although some contributors preferred to remain anonymous. Even with the departure of Standard and Poor's in 2012, it has been said that there are still too many research houses in the Australian market. Some such as Mr Tim Murphy, co-Head of Fund Research at Morningstar, and Mr Mark Thomas, Chief Executive

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14 Ruth Williams, 'Research houses facing the heat', *Sydney Morning Herald*, 1 May 2012, http://www.smh.com.au/business/research-houses-facing-the-heat-20120430-1xuy6.html (accessed 12 June 2013).

Officer at van Eyk Research, have argued that the only reason that so much research exists in Australia is that Australia still permits a pay-for-ratings model (direct 'upstream' payments) that underwrites to some extent the business models of certain research houses.[15]

2.28 A corollary of the pay-for-ratings model is that it may have a negative impact on the perceived value for money of the investment research provided by those research houses that do not accept fees for rating fund managers and that rely to a greater extent on charging financial planners for the research.[16]

2.29 By contrast, others such as Mr Giles Gunesekera, Head of Third Party Sales at Principal Global Investors have argued that the diversity of research houses in the Australian market adds depth and rigour, and that there is no evidence that conflicts of interest in the pay-for-ratings model have any discernible impact on the outcomes of investment research.[17] These arguments are also put forward by Lonsec in chapter 3.

Recent regulatory developments

2.30 The global financial crisis gave rise to concerns about the impact of conflicts of interest within the credit ratings and research report sectors and the adequacy of existing regulations.[18] On 22 May 2008, the former Minister for Superannuation and Corporate Law, Senator the Hon. Nick Sherry MP, announced a review into the regulation of credit rating agencies and research houses. Following a joint report in

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15 See the arguments cited in Benjamin Levy, 'Lonsec named Research House of the Year for 2012', *Money Management*, 27 August 2012, http://www.moneymanagement.com.au/analysis/rate-the-raters/lonsec-named-research-house-of-the-year-for-2012 (accessed 11 July 2013);
see also Bela Moore and Milana Pokrajac, 'Rate the raters 2012', *Money Management*, 29 June 2012, http://www.moneymanagement.com.au/analysis/rate-the-raters/rate-the-raters-2012 (accessed 11 July 2013);
Jason Spits, 'Fund managers and research houses – a cold war thaw?', *Money Management*, 5 July 2013, http://www.moneymanagement.com.au/analysis/rate-the-raters/fund-managers-and-research-houses-a-cold-war-thaw (accessed 11 July 2013);
Jason Spits, 'Are there too many ratings houses in Australia?', *Money Management*, 5 July 2013 http://www.moneymanagement.com.au/analysis/rate-the-raters/are-there-too-many-ratings-houses-in-australia (accessed 11 July 2013).

16 See the arguments cited in Jason Spits, 'Fund managers and research houses – a cold war thaw?', *Money Management*, 5 July 2013.

17 See the arguments cited in Jason Spits, 'Fund managers and research houses – a cold war thaw?', *Money Management*, 5 July 2013.

18 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 5.

October 2008 by the Treasury and ASIC,[19] the government instituted reforms to the regulation of credit rating agencies in Australia.[20]

2.31 In November 2011, ASIC released a consultation paper on research houses,[21] followed in December 2012 by its regulatory guide on research report providers.[22]

Avoiding, controlling and disclosing conflicts of interest

2.32 In its regulatory guide on research report providers, RG 79, ASIC notes that 'indirect conflicts can be as corrosive as direct conflicts to the integrity of the research'. ASIC provides examples of direct and indirect conflicts:

- direct conflicts include circumstances where another part of the business (e.g. investment bank) has provided underwriting or consulting services to an entity that is the subject of the research;
- direct conflicts include issuer commissioned research ('upstream' payment). The research report provider's dependence on the income stream generated by the client relationship has the potential to adversely influence the independence of the research, ratings process and outcome; and
- indirect conflicts include circumstances where the client relationships and revenue streams generated by ancillary business units such as consulting or funds management services may indirectly conflict with the integrity of the research service. Such conflicts may not directly relate to or affect a specific piece of research on a specific product or issuer. Nevertheless, these indirect conflicts share the potential to negatively affect the independence and integrity of the overall research process. Unlike direct conflicts, this impact may not be as readily apparent to a user of the research.[23]

2.33 Section 912A(1)(aa) of the *Corporations Act 2001* requires licensees to 'have in place adequate arrangements for the management of conflicts of interest'.[24]

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19 The Treasury and the Australian Securities and Investments Commission, *Review of credit rating agencies and research houses*, Joint Report, No. 143, October 2008.

20 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 5.

21 Australian Securities and Investments Commission, *Strengthening the regulation of research report providers (including research houses)*, Consultation Paper, No. 171, November 2011, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp171-published-16-November-2011.pdf/$file/cp171-published-16-November-2011.pdf (accessed 12 June 2013).

22 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide No. 79, December 2012.

23 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 32.

24 *Corporations Act 2001*, ss. 912A(1)(aa).

2.34 Given that research houses face conflicts of interest in relation to the funds and products that they assess, RG 79 identified the management, and where necessary, the avoidance of conflicts of interest, as a core element in improving the 'credibility and integrity' of research. RG 79 does not prohibit research houses from accepting payments from product issuers to research an issuer's products. Rather, ASIC requires the conflict of interest to be 'effectively and robustly managed'.[25]

2.35 The committee notes that RG79 will come into effect on 1 September 2013. ASIC will conduct surveillance to monitor the effective management of conflicts of interest, and it has given notice that it reserves the right to revisit conflict avoidance if research standards do not improve.[26]

Quality and transparency of the research report

2.36 RG 79 sets out the criteria for quality and transparency in research methodology and the processes used to compile a research report. ASIC expects a research report to:

- have clear, unambiguous and transparent reasons for recommendations and opinions;
- be based on 'reasonable grounds': objective, verifiable facts and analysis;
- have 'proper purpose': offers or threats of favourable or unfavourable research must not be used to solicit benefits or other business, and research must not be used to unfairly or artificially increase trading volumes or to otherwise generate revenue for the provider's ancillary businesses;
- provide a past performance warning where research ratings are based on past performance;
- have a clear and prominent disclosure statement about who commissioned and paid for the report;
- publish all research (including adverse research) to reduce the perception that conflicts of interest may interfere with the research process and outcome;
- date all research and give users the information to assess whether the research is current; and
- provide both positive and negative research ratings, with access to historical research to counter any perception that conflicts of interest may influence the ratings process.[27]

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25 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 7.

26 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 7.

27 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, pp 23–28.

2.37 ASIC proposes further measures in RG 79 that it considers to be best-practice for research houses. These measures include:

- back-testing 'the past performance of researched or rated products against relevant benchmarks';[28]
- mentoring, supervision, and ongoing training and development for research analysts as a response to continuing innovation in financial products;[29] and
- subjecting all research reports to evaluation such as peer review.[30]

Financial planners and financial advisers

Background

2.38 The financial planning and advice industry has been a key focus of this committee through the 2009 Inquiry into Financial Products and Services,[31] The Trio inquiry in 2012, various bill inquiries into the Future of Financial Advice (FOFA) legislation, and the proposed amendments to the *Corporations Act 2001* to restrict the use of the terms 'financial planner' and financial adviser'.[32]

2.39 The next section describes business models (such as vertical integration) in the financial planning and financial advisory sector. It also gives a brief outline of the conflicted remuneration models that existed in the financial planning and financial advisory industry prior to FOFA. This is followed by a summary of the FOFA reforms.

2.40 The committee notes, however, that despite the FOFA reforms, concerns have been expressed in the media that FOFA does not adequately address the conflicts of interest arising from vertical integration in the financial planning and financial advice

28 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 20.

29 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 22.

30 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 22.

31 Parliamentary Joint Committee on Corporation and Financial Services, *Inquiry into financial products and services in Australia*, November 2009.

32 Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment (Future of Financial Advice) Bill 2011 and Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011*, February 2012; Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2013*, May 2013.

industry.[33] These concerns and the responses to them by roundtable participants are discussed in chapter 3 in the section on the quality of financial advice and the relationships that financial advisers have with research houses and fund managers.

Business models and remuneration

2.41 A significant degree of vertical integration exists in the financial services sector whereby large banks and financial conglomerates own a fund management arm that creates financial products and also own large financial advisory dealer groups that may recommend these products.

2.42 In its submission to the committee's financial products and services inquiry in 2009, ASIC noted that there were '749 adviser groups operating over 8,000 practices and employing around 18,200 people'. However, large dealer groups and banks dominate with the top 20 dealer groups having approximately 50 per cent market share. In 2009, the top groups included Professional Investment Services, AMP Financial Planning, Count Wealth Accountants, Commonwealth Financial Planning, ING-ANZ, AMP Group, Aviva Group, AXA Australia, NAB and Commonwealth Bank.[34]

2.43 As a consequence of vertical integration, the committee's report noted:

> Around 85 per cent of financial advisers are associated with a product manufacturer, either as financial advisers working within the group and using the dealer's support services or as directly employed authorised representatives under that corporate entity's AFSL.[35]

2.44 Furthermore, of the remaining financial advisers, many received commissions from product manufacturers. ASIC therefore concluded that in addition to providing advice, the vast majority of financial planners and financial advisers acted as a sales force for product manufacturers.[36]

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33 Leng Yeow, 'This advice will remain unchanged', *Australian Financial Review*, 29 June 2013, p. 17;
David Potts, 'A new year's fizzer', *The Age*, 26 June 2013, http://www.theage.com.au/money/planning/a-new-years-fizzer-20130625-2otfr.html (accessed 26 June 2013);
The Sydney Morning Herald, Editorial, 'Legal reforms will not let ASIC off the hook', 22 June 2013, p.13.

34 Australian Securities and Investments Commission, *Submission 378*, pp 108–109, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

35 Parliamentary Joint Committee on Corporation and Financial Services, *Inquiry into financial products and services in Australia*, November 2009, p. 16.

36 Australian Securities and Investments Commission, *Submission 378*, p. 110, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

2.45 The various business models in the financial advisory sector were explained by ASIC in their submission to the financial products and services inquiry:

- Medium to large sized 'dealer groups' that often operate like a franchise where the licensee offers back office support. The advisers operate as authorised representatives who retain a right to take clients with them if they move to another licensee. The licensee is paid a proportion of the remuneration made by the authorised representative. Example: AMP Financial Planning.
- Institutional-owned financial adviser firms with employed advisers. Advisers in bank owned financial adviser firms are generally employed by the bank. Advisers are paid a proportion of the commissions earned or salaries or a combination of both. Example: Westpac Financial Planning.
- Smaller firms that have their own licence and might outsource compliance functions to specialist dealer services providers such as Paragem Partners or to large dealer groups who provide dealer to dealer compliance services. Example: Securitor.[37]

2.46 Prior to FOFA, ASIC advised that in 2008, only 16 per cent of total advisor revenue came from fee-for-service. The proportion was higher among truly independent advisers. The vast majority of remuneration came from commissions paid by product manufacturers and volume-based bonuses:

> Because an explicit fee for service would likely be perceived by retail investors as high in relation to the value of advisory services, most financial advisers tend to charge low or zero fees for service, in order to encourage business. They then get remuneration indirectly by receiving commissions from product manufacturers on the funds invested by retail investors. Product manufacturers recover the costs of commissions from the overall charges within the investment products.
>
> Trailing commissions (usually 0.6% of account balances) are the main remuneration method for financial planners, with seven in ten planners citing them as a form of remuneration. Other forms of remuneration include initial commission on new investment/contribution (up to 4-5% of contributions), volume bonuses (i.e. additional commission of up to 0.25% of account balances), and fee for service charged to the client (up to 1% of account balance, or a flat fee, perhaps related to the hours involved). These amounts would not all be paid at the maximum level.
>
> Trailing commissions are more common among aligned independent and aligned planners, while bank-based planners favour up-front commissions.[38]

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37 Australian Securities and Investments Commission, *Submission 378*, pp 109–110, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

38 Australian Securities and Investments Commission, *Submission 378*, pp 110–111, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

2.47 After considering the business models in the financial planning and advisory sector, the committee highlighted the sales-advice conflict: that is, the sales imperative within the business structure of the vast majority of the financial advisory sector may conflict with the financial advisers' duty to provide advice that best suits the needs of the client.

2.48 Accordingly, the committee's report on financial products and services recommended that the *Corporations Act 2001* be amended to explicitly include a fiduciary duty for financial advisers to place their clients' interests ahead of their own, and that payments from product manufacturers to financial advisers should be banned. The FOFA provisions arose out of these recommendations and are covered next.

Future of Financial Advice (FOFA) reforms

2.49 The FOFA provisions came into force from 1 July 2013. Between December 2012 and March 2013, ASIC issued five regulatory guides on FOFA. They are:

- RG 246 on the 'conflicted remuneration provisions' in Divisions 4 and 5 of Part 7.7A of the Corporations Act 2001;[39]
- RG 245 on the disclosure provisions in the FOFA reforms;[40]
- RG 183 that, among other matters, clarified exemptions from the 'opt-in' requirement;[41]
- RG 175 on the 'best interests' duty of financial product advisers;[42] and
- RG 244 on scaled advice.[43]

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39 Australian Securities and Investments Commission, *Conflicted remuneration*, Regulatory Guide, No. 246, March 2013, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg246-published-4-March-2013-B.pdf/$file/rg246-published-4-March-2013-B.pdf (accessed 22 July 2013).

40 Australian Securities and Investments Commission, *Fee disclosure statements*, Regulatory Guide, No. 245, January 2013, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg245-published-25-January-2013.pdf/$file/rg245-published-25-January-2013.pdf (accessed 22 July 2013).

41 Australian Securities and Investments Commission, *Approval of financial services sector codes of conduct*, Regulatory Guide, No. 183, March 2013, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg183-published-1-March-2013.pdf/$file/rg183-published-1-March-2013.pdf (accessed 22 July 2013).

42 Australian Securities and Investments Commission, *Licensing: Financial product advisers—Conduct and disclosure,* Regulatory Guide, No. 175, December 2012, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg-175-published-13-December-2012.pdf/$file/rg-175-published-13-December-2012.pdf (accessed 22 July 2013).

43 Australian Securities and Investments Commission, *Giving information, general advice and scaled advice*, Regulatory Guide, No. 244, December 2012, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg-244-published-13-December-2012.pdf/$file/rg-244-published-13-December-2012.pdf (accessed 22 July 2013).

2.50 Two of the key provisions in the FOFA legislation are the ban on commissions on superannuation and investment products, and the fiduciary duty for financial planners and financial advisers to act in the best interest of their clients.

2.51 Prior to FOFA, a financial planner or financial adviser could charge a client on-going fees regardless of the level of service provided. Under FOFA, however, 'opt-in' and fee disclosure requirements have been introduced that mean advisers must gain client consent for on-going fees:

> Advisers will be required to request their retail clients opt-in, or renew, their advice agreements every two years if clients are paying ongoing fees. In addition, an annual statement outlining the fees charged and services provided in the previous 12 months must be provided to clients paying ongoing fees. This means advisers will be in regular contact with their clients and will need to demonstrate the value of the services they are providing their clients.[44]

2.52 However, there is a provision for exemption from the 'opt in' requirements if a financial planner or financial adviser can show ASIC that they are bound by a code of conduct that achieves a similar outcome to 'opt-in'.

2.53 The Financial Planning Association (FPA) has submitted its code to ASIC. Should ASIC find the code acceptable, approximately 8500 FPA practitioners would be exempt from the 'opt-in' requirements. The Association of Financial Advisers is also drafting its own code of conduct, which if accepted, would exempt another 2000 practitioners from 'opt-in'.[45]

Custodians

Background

2.54 Chapter 7 of the *Corporations Act 2001* states that under an arrangement between a provider and a client, the custodian holds a financial product, or a beneficial interest in a financial product, in trust for, or on behalf of, the client or another person nominated by the client.[46] In other words, a custodian holds the assets of another party for safekeeping. The Australian Custodial Services Association (ACSA) defines custody as the:

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44 The Treasury, Future of Financial Advice, Frequently asked questions, What are the key elements of the reforms, http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=faq.htm (accessed 22 July 2013).

45 Leng Yeow, 'This advice will remain unchanged', *Australian Financial Review*, 29 June 2013, p. 17.

46 *Corporations Act 2001*, ss766E(1).

safekeeping of assets (such as shares, bonds and other investments). The safekeeping function reduces risk for clients (asset owners), and provides the definitive book of record for institutional holdings and transactions.[47]

2.55 The use of a custodian means that the assets are separated from the investment manager, and it is argued, the assets are therefore better protected in the case of the insolvency of a RE or trustee.[48]

2.56 Although the principal role of a custodian is the safekeeping of assets and the settlement of securities transactions, additional custodian services may involve administration of the fund or scheme including unit pricing, tax and statutory reporting, portfolio/fund valuation, and unit registry services.[49]

2.57 Furthermore, where trustees do not satisfy the capital requirements of either APRA for superannuation trustees or ASIC for registered MISs, a custodian is appointed as a condition of a licence being granted to the trustee.[50]

2.58 Custodians fall under the remit of ASIC, but the operations of custodians are also of interest to APRA because custodians provide services to RSEs that are regulated by APRA.[51] Furthermore, where a custodian is an authorised deposit-taking institution, it falls under APRA's supervision.

Size and structure of the industry

2.59 As at 31 December 2011, assets of Australian investors worth approximately $1.82 trillion were held in custody. ASIC expects this figure to increase to $6.4 trillion by 2026.[52]

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47 Australian Custodial Services Association, *The role of the custodian*, p. 7, http://www.custodial.org.au/uploaded_files/news_files_uploads/1335847172_109.pdf (accessed 18 June 2013).

48 One Investment Group, Custody services, http://oneinvestment.com.au/services/custody-services/ (accessed 2 July 2013).

49 Australian Custodial Services Association, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013.

50 Australian Custodial Services Association, *Submission 43*, p. 2, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

51 Australian Prudential Regulation Authority, 'Custodian operations in the superannuation industry', *Insight*, No. 1, 2011, p. 12.

52 Australian Securities and Investments Commission, *Custodial and depository services in Australia*, Report, No. 291, July 2012, p. 4, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep291-published-5-July-2012.pdf/$file/rep291-published-5-July-2012.pdf (accessed 22 July 2013).

2.60 The custodial industry in Australia is highly concentrated among a few firms, with the six largest custodians having 84 per cent of the market:

Major custodians[53]	**Assets in custody**	**Market share (%)**
National Australia Bank Asset Servicing	$539.8 billion	30
JP Morgan Treasury and Securities Services	$366.5 billion	20
BNP Paribas Securities Services	$269.1 billion	15
State Street Global Services	$133.3 billion	7
Citi Global Transaction Services	$119.2 billion	7
HSBC Securities Services	$103.3 billion	5

Expectation gap around the role of the custodian

2.61 The Trio inquiry exposed an expectation gap between what retail investors understood as the role of a custodian and what custodians are legally required to do. There was an expectation that a custodian would act to protect and secure underlying assets. However, in its submission to the Trio inquiry, ANZ laid out the functions of a custodian. Significantly, it noted that custodians are not required to confirm the existence of underlying assets:

> It has been suggested in submissions made to the Committee that a custodian is required to confirm the existence of a fund's underlying assets. This is incorrect. The custodian's role and function, as bare trustee, is to hold assets on behalf and upon instruction of the RE. Its duty, which is owed exclusively to the RE, is to act on proper instructions from the RE in relation to those assets. The role of the RE is to manage the assets of the scheme, including activities such as investment strategies and valuations. A custodian does not have discretion to choose whether or not to act on a proper instruction which is lawfully given by the RE. The custodian has no discretion regarding the investment or management of the custodial assets.[54]

2.62 Given the misunderstanding of the role of the custodian, in its report on Trio, the committee recommended that ASIC should consider changing the name 'custodian'

53 Australian Securities and Investments Commission, *Custodial and depository services in Australia*, Report, No. 291, July 2012, p. 14.

54 ANZ, *Submission 70*, p. 3, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012; see also Australian Custodial Services Association, *Submission 43*, p. 2, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

to a term such as 'Manager's Payment Agent' that better reflected the limited role of the custodian.[55]

Recent developments

2.63 Between 2009 and 2011, ASIC reviewed the Australian custodial industry, including industry liaison and surveillance. In July 2012, ASIC released Report 291, 'Custodial and depositary services in Australia'.[56] The proposed name change was one element of discussion.

2.64 In its submission to Report 291, ACSA argued that changing the name 'custodian' to a term such as depositary would do little to close any expectation gap around the role of a custodian. In particular, ACSA noted that custodian businesses operate globally and that under proposed European Union directives, the terms custodian and depositary will have different meanings and different responsibilities. ACSA expressed concern about the confusion that could arise if Australia diverged 'from globally accepted practice'.[57]

2.65 This perspective was reiterated at the hearing by Mr Paul Khoury, Deputy Chairman of ACSA:

> We are strongly of the view that the title 'custodian' is firmly appropriate, for a number of reasons. Most importantly, we operate in a global environment and, from a consistency perspective that is a broadly well-accepted term that we operate in. But ultimately what we are trying to do is avoid confusion.[58]

2.66 Instead of a name-change, Mr Khoury observed that a better approach would be to educate Australian consumers on the functions and responsibilities of a custodian. He also suggested that specific information about the role of a custodian could be included in prospectuses and product disclosure statements.[59]

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55 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 133, Recommendation 8.

56 Australian Securities and Investments Commission, *Custodial and depository services in Australia*, Report, No. 291.

57 Australian Custodial Services Association, *Submission to ASIC Report 291—Custodial and depository services in Australia: name of custodian*, 6 September 2012, p. 2, http://www.custodial.org.au/uploaded_files/news_files_uploads/1354148479_124.pdf (accessed 19 June 2013).

58 Mr Paul Khoury, Deputy Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, p. 14.

59 Mr Paul Khoury, Deputy Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, p. 14.

2.67 As part of its education campaign, ACSA released a document in 2012, 'The role of a custodian'. The document clearly set out the functions, roles, and responsibilities of a custodian. In it, ACSA cautions that:

> It is important not to ***over*** or ***under*** interpret the benefits provided by the custodian:
>
> - The custody function protects the fund's assets firstly by providing clear separation from each investment manager, and also by ensuring that payments of money and delivery of securities only take place as the result of a proper instruction (and in accordance with the rules and conventions of the relevant market's clearing and settlement functions).
>
>   Additionally, the custodian provides a consolidated view of holdings and transactions. This role, as a trusted record-keeper (across all of the client's assets and portfolios), provides the cornerstone for efficient and consistent reporting and monitoring.
>
>   The custodian does not (and cannot) second guess investment decisions or over-ride proper instructions.
>
> - The role of the custodian is analogous in many respects to that of a bank or credit union processing payments for its customers. Banks or credit unions do not stop payments of customers because they think that spending money on a particular transaction is 'wrong' or 'unwise'. In fact, confidence in the banking system relies on this lack of discretion and client confidentiality.[60]

Trustees

Background

2.68 A trustee is a person or company that holds or administers property or assets on behalf of a beneficiary. A trustee must act in the best interests of the beneficiary and is generally not allowed to benefit or profit from its position unless specified in the trust document. Trustees perform a range of functions involving estate planning and management such as the preparation of wills, Enduring Powers of Attorney, investment and executor and financial administration services.

2.69 In the corporate trustee sector, the three main licensed trustee company roles are as debenture issuers, RE and custodian. However, the Financial Services Council noted that the 'scope of the duties and functions of each role is different … and is determined by the structure of the scheme and the documents that govern the scheme.' For example, the role of an RE is similar to a trustee, but the RE has additional

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60 Australian Custodial Services Association, *The role of the custodian*, p. 9, http://www.custodial.org.au/uploaded_files/news_files_uploads/1335847172_109.pdf (accessed 18 June 2013).

statutory obligations, while a custodian acts as a 'bare trustee', meaning the scope of its obligations to an RE is very narrow.[61]

2.70 Trustee companies often operate as a group of companies with subsidiary companies that hold an RE licence or a custodian licence.[62] For example, One Investment Group holds several AFSLs and is licenced to act as a custodian, as a trustee for unregistered schemes, and as RE for registered schemes.[63]

2.71 The roundtable focussed on the role of company trustees as custodian and as RE.[64] The RE role is covered in the next section.

2.72 The committee was also interested in the role of trustee as it related to superannuation funds. At $1.3 trillion, Australia has the fourth largest funds management market in the world, with approximately 45 per cent of that due to the size of Australia's superannuation savings that now exceed $530 billion.[65] Given that the Trio fraud involved superannuation funds being invested in a fraudulent MIS, the committee wanted to scrutinise the role that superannuation trustees play within the APRA-regulated part of the system as trustees for registrable superannuation entities.

Recent developments

2.73 On 26 March 2008, the Council of Australian Governments agreed that the Australian Government would assume responsibility for regulating traditional services provided by trustee companies. On 6 November 2009, the Corporations Act was amended to include the regulation of traditional services provided by trustee companies under chapters 5D and 7 of the Corporations Act.[66] Traditional services provided by a trustee are now specified as a financial service under section 766A(1A) of the Corporations Act.

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61 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

62 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [2].

63 One Investment Group, Trust services, https://oneinvestment.com.au/trust-services/ (accessed 2 July 2013); One Investment Group, Company overview, https://oneinvestment.com.au/about/ (accessed 2 July 2013).

64 Although debenture trustees were not a focus area at the roundtable, the committee has monitored recent developments in the debenture sector including the recent ASIC consultation paper on strengthening regulation of the sector. See Parliamentary Joint Committee on Corporations and Financial Services, *Statutory Oversight of the Australian Securities and Investments Commission*, No. 2, May 2013, pp 55–58.

65 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 146.

66 The *Corporations Legislation Amendment (Financial Services Modernisation) Act 2009*.

2.74 On 15 March 2010, ASIC issued a consultation paper on the new obligations facing trustee companies, including the requirement to hold an AFSL.[67] Prior to these changes, some trustees already held an AFSL that authorised them to provide custodial and depository services. Companies wishing to provide traditional trustee services along with custodial and depositary services now need to modify their licence to include trustee services.

2.75 Some trustee companies (RSEs) are regulated by APRA. For those traditional trustees not regulated by APRA, the new regulations introduced by ASIC required the trustee to:

- have risk management systems in place to deal with the risk that its financial resources may be inadequate to enable it to continue its business;
- meet specified base level financial requirements; and
- hold at least $5 million in net tangible assets.[68]

Trustee interactions with custodians

2.76 In a recent article, APRA has drawn attention to an expectation gap between what custodians provide to the trustees of an RSE and what trustees assumed they were receiving, particularly in the area of asset valuation:

> Custodians can play key roles in providing investment accounting and unit pricing services to superannuation trustees, and may also provide trustees with investment performance reporting or services such as foreign exchange or currency overlay.
>
> APRA observed that, in a number of cases, trustees rely on custodian information and practices around valuation sources, tax calculation approach and unit pricing methodology without sufficient enquiry or assertion of the trustee's expectations in this area. This is a consistent theme identified by APRA in respect of asset valuations.
>
> Based on APRA's experience, trustees often place reliance on the fact that valuations for unlisted assets are 'sourced' from the custodian and thus assume the valuations to be both robust and independent. However, APRA found that custodians operate predominantly on client trustee instructions and the extent of custodian input in the area of valuation was less than that expected by trustees.[69]

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67 Australian Securities and Investments Commission, *Trustee companies: financial requirements and conduct obligations*, Consultation Paper, No. 132, March 2010, p. 6, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp132.pdf/$file/cp132.pdf (accessed 22 June 2013).

68 Australian Securities and Investments Commission, *Trustee companies: financial requirements and conduct obligations*, Consultation Paper, No. 132, March 2010, p. 10.

69 Australian Prudential Regulation Authority, 'Custodian operations in the superannuation industry', *Insight*, No. 1, 2011, p. 13.

2.77 In 2011, APRA indicated that it would discuss with trustees the extent to which trustees monitored and assessed the accuracy of the information that trustees received from custodians:

> As part of its supervisory practices going forward, APRA will discuss with trustees the extent to which they obtain assurance that unlisted asset valuations used in NAV (net asset valuation) calculations are adequately robust. It is not sufficient to simply state that the NAV is obtained from the custodian and hence it is 'independent'. Trustees also need to assess the source and adequacy of valuation data used by the custodian. In all cases, trustees should remember that the valuation process affects member interests and is a trustee responsibility. Similarly, trustees should have an understanding of the controls in place at the custodian to check the reasonableness of the pricing (valuation) data received. APRA expects trustees to know the extent to which stale price valuations are being monitored and to ensure they are receiving adequate and timely reporting from the custodians on such prices.[70]

2.78 Given the importance of this interaction, the committee was keen to build on APRA's initial work and examine the wider relationship between RSE trustees, custodians and REs, and also between the auditors of those of entities.

Fund managers and Responsible Entities

2.79 In Australia, the term 'managed funds' covers 'two broad types of institutions':

> The first are managed funds institutions (such as life insurance companies, superannuation funds and unit trusts), which buy assets on their own account. The second are investment or fund managers, which act as investment agents for the managed funds institutions, as well as others with substantial funds to invest.[71]

2.80 The inquiry was concerned with the investment fund managers that manage a portfolio of assets and act as the RE for a range of MISs.

Size of the Australian managed funds sector

2.81 The Australian managed funds sector is one of the largest in the world. REs manage a significant amount of non-superannuation assets:

> As at February 2013, over 500 responsible entities operated about 4,000 registered managed investment schemes (schemes). The largest ten investment management groups collectively managed $531 billion for

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70 Australian Prudential Regulation Authority, 'Custodian operations in the superannuation industry', *Insight*, No. 1, 2011, p. 13.

71 Australian Bureau of Statistics, Managed Funds, 1301.0–Year Book Australia, 24 May 2012, http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/by%20Subject/1301.0~2012~Main%20Features~Managed%20funds~268 (accessed 31 May 2013).

> numerous schemes in the September 2012 quarter, amounting to roughly one quarter of the funds under management in Australia. In contrast, smaller investment managers in the sector may only operate one scheme with a relatively small asset value.[72]

2.82 Some of the larger Australian retail fund managers include Australian Ethical, Australian Unity Investments, BlackRock Investments, BT Financial Group, Challenger, Colonial First State, Hunter Hall, Lifeplan Funds Management, Macquarie Group, Man Investments, MLC, OnePath, Perpetual and Zurich.

2.83 The managed funds sector invests in a range of assets including Australian and international shares, infrastructure, fixed income securities, mortgages, property, cash, unlisted private companies, and specialist sectors.[73]

Platforms

2.84 Platforms have become a significant part of the retail investment market with most new investment occurring in this fashion. ASIC describes them as follows:

> A platform is an administration facility that simplifies acquisition and management of a portfolio of investments. Platforms allow retail investors to purchase a range of investments through the one facility. In one sense platforms are like a department store where you can choose from different brand names and products in the one place, rather than having to visit a number of specialty stores.[74]

2.85 Financial planners generally place their clients into platforms because it consolidates the investment reporting process. Retail investors can gain advantage from being placed in a platform because retail funds can be pooled, thereby allowing access to products that are normally reserved for wholesale clients by virtue of the minimum investment requirements (typically $500 000).[75]

2.86 The two most common types of platforms are:

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72 Australian Securities and Investments Commission, *Risk management systems of responsible entities*, Consultation Paper, No. 204, March 2013, p. 5, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp204-published-21-March-2013.pdf/$file/cp204-published-21-March-2013.pdf (accessed 30 May 2013).

73 Australian Securities and Investments Commission, *Risk management systems of responsible entities*, Consultation Paper, No. 204, March 2013, p. 5; Australian Securities Exchange, About managed funds, http://www.asx.com.au/products/about-managed-funds.htm (accessed 31 May 2013).

74 Australian Securities and Investments Commission, *Submission 378*, p. 112, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

75 Australian Securities and Investments Commission, *Submission 378*, p. 112, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

- master trusts – a master trust operates as a managed investment scheme. In a master trust the platform operator (or trustee) owns all the assets and the investors hold units in the managed investment scheme; and
- wrap accounts – a wrap account allows the investor to set up a portfolio of investments where the investment is made in the name of the wrap account operator (or custodian) but the investor has a specific beneficial interest in the assets reflected in the records of the wrap account operator (or custodian). This structure is increasing in popularity. The service 'wraps' or combines investments into a single account to facilitate the management of an investment portfolio.[76]

2.87 Platform providers charge service fees, and fees are also payable on specific platform investments.[77]

Index funds

2.88 In contrast to a professionally/actively managed fund, index funds are passive mutual funds with a portfolio constructed to match or track the components of a market index, such as the Standard & Poor's 500 Index (S&P 500). An index fund typically provides broad market exposure, low operating expenses and low portfolio turnover. The Vanguard 500 Index Fund, launched in the United States in 1976 by Mr Jack Bogle, was the first industry fund for individual investors.[78]

2.89 Research by the American economist, Dr Burton G. Malkiel, indicates that over the last 30 years, passively-held index funds have substantially outperformed the average active fund manager. He also observes that the amount of under-performance is well approximated by the difference in the fees charged by the two types of funds. Dr Malkiel acknowledges that some active management is required for market efficiency because it ensures that information is properly reflected in securities prices. However, he found that 'the number of active managers and the costs they impose far

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76 Australian Securities and Investments Commission, *Submission 378*, pp 112–113, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

77 Australian Securities and Investments Commission, *Submission 378*, p. 112, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

78 Vanguard 500 Index Fund, Funds, stocks and ETF's, https://personal.vanguard.com/us/FundsSnapshot?FundId=0040&FundIntExt=INT (accessed 31 May 2013); see also Justin Fox, Just how useless is the asset-management industry?, *Harvard Business Review blog*, 16 May 2013, http://blogs.hbr.org/fox/2013/05/just-how-useless-is-the-asset-.html (accessed 31 May 2013).

exceed what is required to make our stock markets reasonably efficient' (see chapter 5).[79]

2.90 Although index funds were not the subject of the roundtable discussion, the committee did question the Australian fund managers about the issues raised by Malkiel. The responses by the fund managers are summarised in chapter 5, and the full responses are available in Appendix 2.

Responsible Entities and managed investment schemes

2.91 Section 601ED of the Corporations Act states that an MIS must be registered if it has 20 or more members, or if the scheme is promoted by a person who is in the business of promoting MISs.[80]

2.92 An MIS is typically a collective investment such as a property trust, cash management trust, equity trust, agricultural scheme, timeshare scheme, mortgage scheme or actively managed strata title scheme.[81]

2.93 A registered MIS must appoint an RE,[82] and the RE must be an Australian registered public company that holds an AFSL permitting it to operate the scheme.[83] The scheme must lodge a constitution and compliance plan with ASIC.[84]

2.94 In effect, an RE is a single, clearly identifiable entity that is responsible to investors for the operation of a registered MIS in accordance with the scheme's constitution and compliance plan.[85]

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79 Burton G. Malkiel, 'Asset management fees and the growth of finance', *Journal of Economic Perspectives*, Vol. 72, No. 2, Spring 2013, pp 97–108;
see also Justin Fox, 'Just how useless is the asset-management industry?', *Harvard Business Review blog*, 16 May 2013, http://blogs.hbr.org/fox/2013/05/just-how-useless-is-the-asset-.html (accessed 31 May 2013);
Michael West, 'Fundsters get the nod and the cash to go with it', Weekend Business, *Sydney Morning Herald*, 25 May, p. 2, http://www.smh.com.au/business/fundsters-get-the-nod-and-the-cash-prize-to-go-with-it-20130524-2k6p6.html (accessed 31 May 2013);
Alexander Green, 'Why Burton G. Malkiel is more right than wrong', *Investment U*, Iss. 1299, 12 July 2010, http://www.investmentu.com/2010/July/why-burton-g-malkiel-is-more-right-than-wrong.html (accessed 31 May 2013).

80 *Corporations Act 2001*, s. 601ED.

81 One Investment Group, Responsible entities and managed investment schemes, http://oneinvestment.com.au/responsible-entities-and-managed-investment-schemes/ (accessed 22 July 2013).

82 *Corporations Act 2001*, s. 601EA.

83 *Corporations Act 2001*, s. 601FA.

84 *Corporations Act 2001*, s. 601EA.

2.95 The RE has a trusteeship or fiduciary duty to the investors in the scheme.[86] The extent of an RE's accountability is laid out by Mr Justin Epstein, Executive Director of One Investment Group when he explains that:

> The role of a Responsible Entity today, distinct from other gatekeepers, such as Custodians and Auditors, is to bear the ultimate accountability to investors for a registered scheme. That is, whilst the Responsible Entity is not prohibited from appointing an agent, the legislation states that the Responsible Entity is taken to have done (or failed to do) anything that the appointed agent has done (or failed to do), even where the agent acted fraudulently or outside the scope of their authority or engagement. In this regard, we consider the Responsible Entity to be the critical gatekeeper for registered schemes.[87]

2.96 The Corporations Act requires that all property in a MIS 'is clearly identifiable as scheme property and held separately from the property' of the RE and any other MIS, and that scheme property is valued regularly.[88]

2.97 Since 28 June 2007, however, neither ASIC guidelines nor the Corporations Act have placed restrictions upon the investment strategy of a registered MIS. This has allowed a registered MIS to diversify into, for example, foreign investments.[89]

Responsible Entity business models

2.98 There are two forms of RE: internal, where the manager of the scheme and the RE are related body corporates, and external where the RE is independent of the manager of the scheme and does not own or control the MIS.[90] One Investment Group operates as an external RE for registered schemes, as well as a trustee and custodian. BT Financial Group is a large financial services conglomerate that operates an internal RE function, as well as being a fund manager.

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85 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1]; Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

86 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

87 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

88 Australian Securities and Investments Commission, *Submission 51*, p. 36, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

89 Australian Securities and Investments Commission, *Submission 51*, pp 86–87, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

90 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

2.99 The majority of REs are multi-function REs that operate more than one scheme. The Corporations and Markets Advisory Committee noted in a report published last year that:

- 39 per cent of REs operate one scheme;
- 32 per cent of REs operate more than one, but less than 5, schemes;
- 26 per cent of REs operate 5 or more, but fewer than 50, schemes (e.g. Trio); and
- 3 per cent of REs operate 50 or more schemes.[91]

2.100 Of the 500 plus REs operating in Australia, there are 33 dual-regulated entities that hold both an AFSL from ASIC to operate as a RE, and a RSE licence from APRA to operate as an RSE.[92] Trio Capital was a dual-regulated entity.

Compliance plans

2.101 Section 601HA of the Corporations Act requires each registered MIS to have a compliance plan that sets out adequate measures for the RE to undertake to ensure that the MIS complies with its legal obligations under its constitution and the Corporations Act.[93]

2.102 However, ASIC warns of a 'fundamental risk' that the RE of an MIS may not follow 'the rules set out in the managed investment scheme's constitution or the laws governing registered managed investment schemes'.[94]

2.103 Chapter 5C of the Corporations Act aims to address the risk that an RE may not comply with its duties by setting out requirements for compliance plans, compliance audits and compliance committees.

Compliance committees

2.104 Each registered MIS must have a compliance plan committee 'made up of independent and other auditors who are charged with the role of monitoring the RE's adherence with the plan and other scheme governing documents'.[95]

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91 Australian Government Corporations and Markets Advisory Committee, *Managed Investment Schemes*, Report, July 2012, p. 60.

92 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 11.

93 *Corporations Act 2001*, s. 601HA.

94 Australian Securities and Investments Commission, *Submission 51*, p. 35, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

95 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

2.105 Section 601JA of the Corporations Act requires each registered MIS to establish a compliance committee if less than half the directors of the RE are external directors.[96] The compliance plan committee is 'made up of independent and other auditors who are charged with the role of monitoring the RE's adherence with the plan and other scheme governing documents'.[97]

2.106 However, at the time of the Trio inquiry, ASIC noted that there were no 'legislative requirements as to experience, competence or qualifications for compliance committee members' and that there was no requirement for prospective compliance committee members to undergo training.[98]

Recent developments

2.107 In March 2013, ASIC released a consultation paper that proposed changes to the risk management systems of those REs that are not regulated by APRA. The proposed regulations would also apply to dual-regulated entities (entities that are regulated by both ASIC and APRA). The changes include a focus on fundamental risk management practices, fostering a risk management culture, and reviewing the effectiveness of risk management systems.[99]

Auditors

Background

2.108 Auditors undertake a crucial role in the financial services system, scrutinising both the financial statements and the compliance plans of entities.

2.109 Auditing standards in Australia are governed by the Corporations Act. The Auditing and Assurance Standards Board is established by section 227 of the ASIC Act.[100] It is responsible for developing auditing standards in Australia.[101] The

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96 *Corporations Act 2001*, s. 601JA.

97 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

98 Australian Securities and Investments Commission, *Submission 51*, p. 43, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

99 Australian Securities and Investments Commission, *Risk management systems of responsible entities*, Consultation Paper, No. 204, March 2013, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp204-published-21-March-2013.pdf/$file/cp204-published-21-March-2013.pdf (accessed 24 June 2013) .

100 *ASIC Act 2001*, ss. 227AA(1).

101 *Corporations Act 2001*, s. 307A, ss. 336(1).

Australian Auditing Standards are based on the International Auditing and Assurance Standards Board International Standards on Auditing. [102]

2.110 Audits must be conducted in accordance with legally enforceable auditing standards that were introduced for financial reporting periods from 1 July 2006, following the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*.

2.111 Australia's financial reporting system is established by Part 12 of the *Australian Securities and Investments Commission Act 2001* (the ASIC Act). One of the main objects of section 224 of the ASIC Act is to develop auditing and assurance standards that:

- provide Australian auditors with relevant and comprehensive guidance in forming an opinion about, and reporting on, whether financial reports comply with the requirements of the Corporations Act; and
- require the preparation of auditors' reports that are reliable and readily understandable by the users of the financial reports to which they relate.[103]

Key auditor attributes

2.112 Auditor independence is a fundamental principle of the external auditing system.[104] By virtue of this independence from the other gatekeepers, auditors occupy a critical role in the financial services system given that the other gatekeeper roles including research, custody, trustee, RE, fund manager, financial planner and financial adviser can all function together as part of one large financial services corporation.

2.113 The Auditing and Assurance Standards Board (AUASB) has developed a set of requirements to which independent auditors are required to adhere. These include independence, and the application of professional scepticism and professional judgement. In addition, in order to obtain reasonable assurance, an auditor is expected to obtain:

> sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.[105]

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102 Strategic Direction issued by the Financial Reporting Council (FRC) to the Auditing and Assurance Standards Board (AUASB) on 6 April 2005, published in Auditing and Assurance Standards Board, *AUASB Functions and Processes*, November 2012, p. 5.

103 *ASIC Act 2001*, ss. 224(aa).

104 *Corporations Act 2001*, s. 307C.

105 Auditing and Assurance Standards Board (AUASB), *Auditing Standard ASA 200—Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with the Australian Auditing Standards*, October 2009, paragraphs 14–17.

Treasury consultation paper

2.114 In March 2010, a Treasury consultation paper found that Australia's 'audit regulation framework is robust and stable' and 'in line with international best practice'.[106]

2.115 In particular, Treasury emphasised two crucial and unique attributes applicable to Australia. Firstly, that as a statutory body under federal legislation, ASIC regularly reviews the audit process with its audit inspection program. And, secondly, that accounting and auditing standards and auditor independence are all legally enforceable under the Corporations Act.[107] These two factors contributed significantly to the robustness of the audit regulation framework.

ASIC's audit inspection program and the response from the audit profession

2.116 Following the release of its audit inspection program report for 2011–12, ASIC has placed the audit industry on notice regarding the quality of financial statement audits.[108] In its recent ASIC Oversight reports, the committee questioned both ASIC and the audit profession at length about the steps that are being taken to raise the level of audit quality in Australia.[109]

2.117 The committee notes that on 13 June 2013, ASIC welcomed the development by each of the six largest audit firms in Australia of 'a genuine and comprehensive action plan to improve audit quality', noting that each firm had 'taken full ownership for the timely implementation of the plan and monitoring its effectiveness'.[110]

2.118 ASIC asked the six firms 'to focus on improving the consistency of the execution of audits' and to address the three broad areas requiring improvement that were identified in ASIC's audit inspection report:

- the sufficiency and appropriateness of audit evidence obtained by the auditor;
- the level of professional scepticism exercised by auditors; and

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106 The Treasury, *Audit Quality in Australia: A Strategic Review*, March 2010, p. 7.

107 The Treasury, *Audit Quality in Australia: A Strategic Review*, March 2010, p. 3.

108 Australian securities and Investments Commission, *Audit inspection program report for 2011–12*, Report No. 317, December 2012.

109 Parliamentary Joint Committee on Corporations and Financial Services, *Statutory Oversight of the Australian Securities and Investments Commission*, No. 2, May 2013, pp 5–23.

110 Australian Securities and Investments Commission, 'ASIC welcomes audit firm plans to improve quality', Media release, No. 13–138, 13 June 2013, http://www.asic.gov.au/asic/asic.nsf/byheadline/13-138MR+ASIC+welcomes+audit+firm+plans+to+improve+quality?openDocument (accessed 14 June 2013).

- the extent of reliance that can be placed on the work of other auditors and experts.[111]

2.119 In working with the firms, ASIC notes that the action plans will focus on:

- the culture of the firm, including messages from firm leadership focusing on audit quality and consultation on complex audit issues;
- the experience and expertise of partners and staff, including increased and better use of experts;
- supervision and review, including greater partner involvement in working with audit teams in the planning and execution of audits, and new or increased real time quality reviews of engagements; and
- accountability, including impacts on remuneration of engagement partners and review partners for poor audit quality, often extending the impacts to firm leadership.[112]

CPA Australia guide to auditing and assurance

2.120 In February 2013, CPA Australia released 'A guide to understanding auditing and assurance'. Mr Alex Malley, Chief Executive Officer of CPA Australia notes that the guide:

> explains the value and purpose of auditing and assurance in plain language. This should assist shareholders who are not experts in auditing and assurance to better understand the messages from their company’s auditor, and make use of this information in their decision making.[113]

2.121 The guide addresses some of the expectation gaps that have been highlighted in the wake of recent corporate collapses. In particular, it addresses the meaning and extent of the 'reasonable assurance' that is obtained in an audit of financial statements:

> While the reasonable assurance obtained in an audit is a high level of assurance, it is not absolute assurance (a certification that the financial statements are completely correct). Obtaining absolute assurance is not possible in financial statement audits for a number of reasons, including:
>
> - it would be impractical for the auditor to test and audit every transaction; and
> - financial statements involve judgements and estimates which often cannot be determined exactly, and may be contingent on future events.[114]

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111 Australian Securities and Investments Commission, 'ASIC welcomes audit firm plans to improve quality', Media release, No. 13–138, 13 June 2013.

112 Australian Securities and Investments Commission, 'ASIC welcomes audit firm plans to improve quality', Media release, No. 13–138, 13 June 2013.

113 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 5, http://www.cpaaustralia.com.au/cps/rde/xbcr/cpa-site/guide-understanding-audit-assurance.pdf (accessed 21 March 2013).

114 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 7.

2.122 By contrast, the half-yearly review of financial statements by an auditor only provides limited assurance.[115]

2.123 The guide also deals with unmodified and modified opinions and explains that an emphasis of matter paragraph is not a qualification, limitation, or adverse conclusion:

> An unmodified auditor's report effectively states the auditor believes the financial statements present a true and fair view, and are in accordance with accounting standards and relevant legislation. This is sometimes also called an 'unqualified' or a 'clean' audit opinion.
>
> […]
>
> An unmodified review report effectively states the reviewer did not become aware of anything that suggested the financial statements do not present a true and fair view in accordance with accounting standards.
>
> In some circumstances, the auditor will include additional wording in the auditor's report directing users to information that in their view is fundamental to understanding the financial statements. This may be information included in the financial statements, such as a note (called an 'emphasis of matter' paragraph), or information that is included elsewhere (called an 'other matter paragraph'). It is important to note that an emphasis of matter or other matter paragraph is not a qualification, limitation or adverse conclusion.
>
> […]
>
> Modified auditor's reports are issued when the auditor believes the financial statements contain a material misstatement, or when the auditor is unable to obtain enough evidence to form an opinion.[116]

2.124 In response to a request from the committee, CPA Australia clarified the distinction between an emphasis of matter and a modified audit opinion:

> There is a clear distinction between an emphasis of matter and modified audit opinion:
>
> - a modified audit opinion is required where the financial statements are *materially misstated* or the auditor is unable to form a conclusion due to a *limitation of scope*; and
> - emphasis of matter paragraphs highlight matters that are *not materially misstated* in the financial statements but which in the auditors' judgement are of such importance so as to be fundamental to users' understanding of the financial statements.
>
> The use of an emphasis of matter paragraph does not ever replace the need for a modified audit opinion where the financial statements are materially

115 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 7.

116 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, pp 8–9.

> misstated - hence rather than representing a threshold, modified audit opinions and emphasis of matter paragraphs are two different things or heterogeneous.
>
> Professional judgement is relevant to both of these aspects as it would be involved in forming a conclusion in regard to a material misstatement of the financial statements, and also in determining whether a matter is of such importance that it is fundamental to users' understanding of the financial statements. Australian auditing standards contain comprehensive requirements including general principles and specific rules where appropriate, together with a range of guidance statements that have been issued by the AUASB. However, the availability of this material does not replace the need for experience and professional judgement in performing an audit.[117]

2.125 Fraudulent activity can result in the material misstatement of financial statements. CPA Australia observes that even though an audit is not designed to uncover all instances of fraud, 'it is reasonable to expect that an audit would detect instances of fraud that result in material misstatement'.[118]

2.126 An auditor also makes a judgement about the ability of a company to continue as a going concern for the 12 months subsequent to the audit. This assumption may be inherently difficult to determine. Furthermore, investors need to be clear about the nature of an emphasis of matter paragraph if the company has already disclosed uncertainty about its ability to continue as a going concern:

> The going concern assumption involves judgements about events taking place in the future, which are inherently uncertain. Where there is significant uncertainty in the company's ability to continue as a going concern and this has been disclosed by management in the financial statements, the auditor includes wording in the auditor's report to direct users to the applicable note in the financial statements. This is called an emphasis of matter paragraph. If the auditor ultimately does not agree with management's assumptions in regard to going concern, the result would be a modified opinion.[119]

2.127 Finally, and very importantly, an unmodified auditor's report is an opinion about the state of the company's financial statements that provides investors 'with a higher degree of confidence that the information is materially correct and unbiased. The audit does not, however, express an opinion 'about the state of the company itself or whether it is a safe investment'. In a similar way, the audit assesses 'the going concern assumptions used by management in preparing the financial statements'.

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117 CPA Australia, correspondence to the committee, 12 July 2013 (emphasis original); see also Ernst & Young, answer to question on notice, 10 July 2013 (received 16 July 2013).

118 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 12.

119 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 12.

However, the audit opinion 'cannot be taken as a conclusion on the solvency or financial health of the company'.[120]

Structure of the audit industry and conflicts of interest

2.128 The audit industry in Australia and globally is dominated by four large audit firms: PricewaterhouseCoopers, Deloitte, Ernst & Young and KPMG. This has raised concerns both internationally and within Australia about the extent of competition within the audit market and its potential impacts on audit quality.

2.129 In February 2013, the United Kingdom (UK) Competition Commission issued the provisional findings of its market investigation into the supply of statutory audit services to large companies in the UK. It concluded that competition in the audit market 'is restricted by factors which inhibit companies from switching auditors and by the tendency for auditors to focus on satisfying management rather than shareholder needs'.[121]

2.130 Ms Laura Carstensen, Chair of the UK Audit Investigation Group, found that existing safeguards, such as audit committees, appeared insufficient to prevent misaligned auditor incentives or to facilitate a dynamic and independent auditing market:

> Shareholders play very little role in appointing auditors compared to executive management-and despite the presence of audit committees and other safeguards-audit firms naturally focus more on meeting management interests. The result is a rather static market in which too often audits don't fulfil their intended purpose and thus fail to meet the needs of shareholders.
>
> It is clear that there is significant dissatisfaction amongst some institutional investors with the relevance and extent of reporting in audited financial reports. This needs to change so that external audit becomes a more genuinely independent and challenging exercise where auditors are less like corporate advisors and more like examining inspectors.[122]

2.131 In its previous ASIC oversight report, the committee expressed concern about the potential conflict of interest that arises when an audit firm has to balance

120 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 13.

121 Competition Commission (UK), 'Audit market not serving shareholders', Media release, 22 February 2013, www.competition-commission.org.uk/media-centre/latest-news/2013/Feb/audit-market-not-serving-shareholders (accessed 27 March 2013).

122 Ms Laura Carstensen, Chair, UK Audit Investigation Group, cited in Competition Commission (UK), 'Audit market not serving shareholders', Media release, 22 February 2013, www.competition-commission.org.uk/media-centre/latest-news/2013/Feb/audit-market-not-serving-shareholders (accessed 27 March 2013).

commercial pressures (retaining client contracts) with adherence to audit quality (highlighting matters of concern in financial statements and/or compliance plans).[123]

Compliance plan audits

2.132 Section 601HG of the Corporations Act requires the compliance plan of the RE to be audited annually. Under section 601HG(2) of the Corporations Act, the auditor of an entity's compliance plan cannot be the auditor of that entity's financial statements, although the auditors may work for the same audit firm.

2.133 The compliance plan auditor is required to state in its report whether the RE complied with the MIS's compliance plan during the financial year and whether the plan continues to meet the requirements of Part 5C.4 of the Corporations Act.

2.134 According to ASIC however, Part 5C.4 of the Corporations Act 'does not impose any qualitative standards by which a compliance plan auditor must conduct their audit' and 'does not make it an offence to conduct a poor quality compliance plan audit'. Furthermore, the auditor is only required to check compliance with the compliance plan, not the compliance of the RE with the Corporations Act or the constitution of the MIS.[124]

2.135 Finally, the assurance standards for a compliance plan audit do not have the force of law, unlike the assurance standards for an audit of financial statements. At the time of the Trio inquiry, ASIC observed that there is no precedent for a successful action against a compliance plan auditor.[125]

Audits of self-managed superannuation funds

2.136 From 1 July 2013, the *Superannuation Laws Amendment (Capital Gains Tax Relief and Other Efficiency Measures) Act 2012* introduced a requirement for auditors of self-managed superannuation funds (SMSF) to register with ASIC to conduct

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123 See the interchange between Mr Paul Fletcher MP and Ms Liz Stamford, Head of Audit Policy, Institute of chartered Accountants Australia, *Committee Hansard*, 15 March 2012, pp 9–10; Parliamentary Joint Committee on Corporations and Financial Services, *Statutory Oversight of the Australian Securities and Investments Commission,* No. 2, May 2013, Committee views—2.63–2.65, pp 22–23.

124 Australian Securities and Investments Commission, *Submission 51*, pp 44–45, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

125 Australian Securities and Investments Commission, *Submission 51*, p. 45, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

SMSF audits.[126] The registration system administers a competency exam designed to test critical judgement in relation to superannuation requirements and tax compliance.[127]

Key issues involving auditors

2.137 In its report into the collapse of Trio, the committee drew attention to the role of auditors and expressed concern that:

- an auditor's approval of financial statements does not necessarily mean that the actual assets underlying the financial statements exist;
- an auditor's assessment of a compliance plan and the work of the compliance committee as 'effective' essentially only means that they exist; and
- in the case of Trio, the requirement for the auditors to demonstrate 'professional scepticism' about the information given to them was insufficient to prevent the loss of investors' funds.[128]

2.138 At the roundtable, the committee was interested in several aspects of compliance plans including the adequacy of compliance plans, the capabilities of compliance committees, the degree of independence that compliance committees have from the management of the RE, the auditing of compliance plans, the relationships that the audit profession had with the compliance committees of REs and RSEs, and the degree of cross-referencing between financial statement and compliance plan audits.

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126 *Superannuation Laws Amendment (Capital Gains Tax Relief and Other Efficiency Measures) Act 2012*. Registration eligibility requirements include a competency examination, educational qualifications and supervised practical experience. See ASIC, 'SMSF auditor registration', www.asic.gov.au/asic/ASIC.NSF/byHeadline/SMSF%20auditor%20registration (accessed 26 March 2013).

127 Mr Greg Tanzer, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 15 March 2013, pp 27–28.

128 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2013, pp xxii–xxiii.

Chapter 3

Interaction between research houses, fund managers, financial planners and financial advisers

Introduction

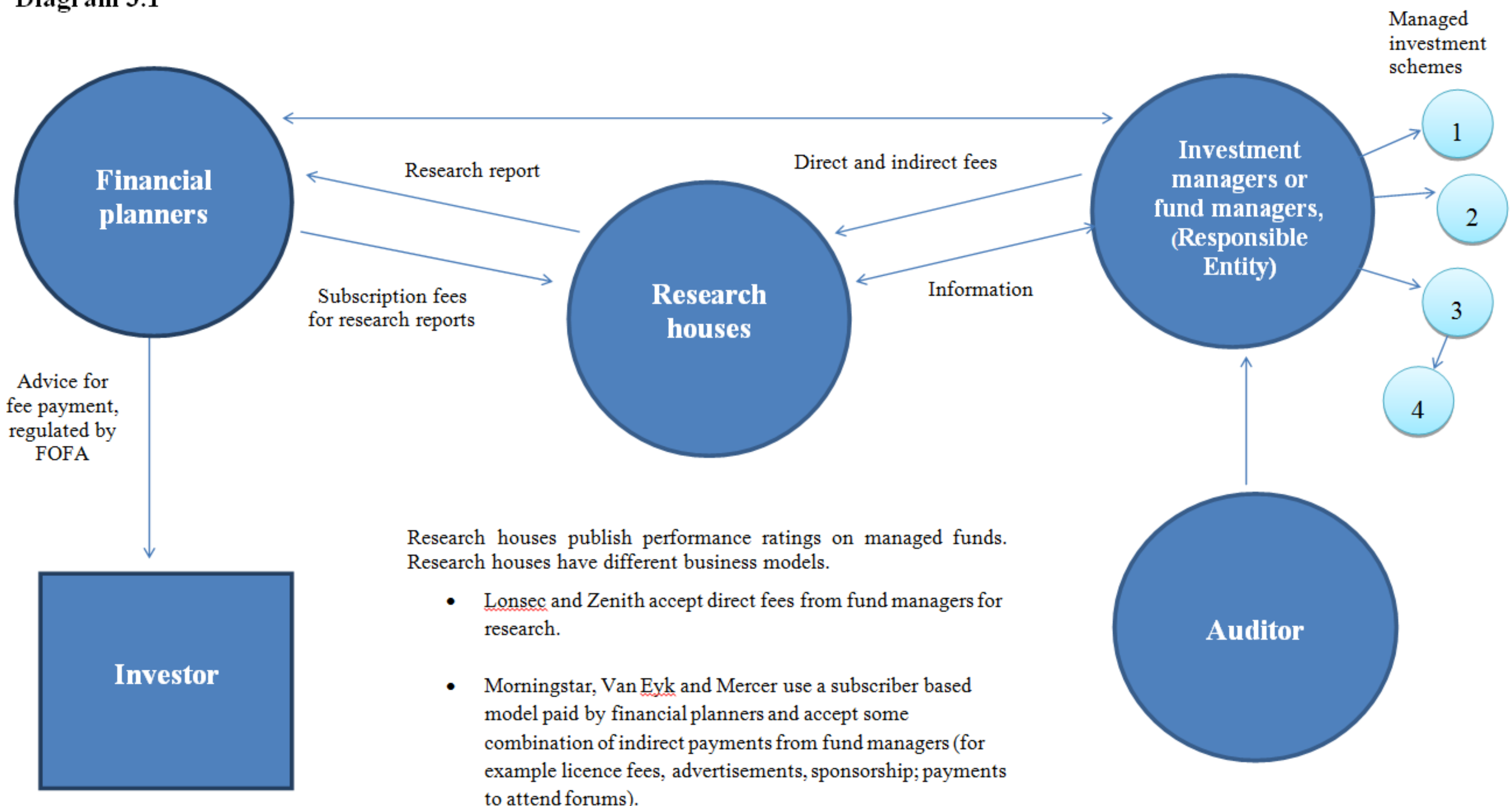
3.1 The next three chapters present the evidence from the gatekeepers' roundtable. It is important in considering this evidence to bear in mind the different business models within gatekeeper groups, and the potential impact that those differences can have on the interactions between gatekeeper groups. As discussed in the previous chapter, these differences include:

- the subscription model and the pay-for-research/ratings models, and the differences between direct and indirect payments in the research house sector;
- the operation of internal research functions by some advisory groups; and
- the vertical integration in large parts of the financial services system where banks and/or fund managers are either affiliated with, or own, financial planning and financial advisory dealerships.

3.2 With these differences in mind, the committee devised diagrams 3.1 and 4.1, representing how the gatekeepers may interact. Gatekeepers' functions are not necessarily performed by companies operating solely in one part of the financial services sector. In some instances, all the gatekeeper functions—except auditing—are performed by different entities within the same corporation. For example, entities within Macquarie Group offer fund management, RE services, custody services, trustee services, financial advice and private banking. Likewise, entities within BT Financial Group offer fund management, RE services, trustee services, financial planning and private banking. Both Macquarie Group and BT Financial Group also have an internal research function. Several of the other gatekeepers also offer multiple services. The auditors are the exception in this regard, operating independently of the functions of the other gatekeepers in the system.

3.3 This chapter deals with the interactions shown in diagram 3.1 between research houses, financial planners and financial advisers, and fund managers. A key focus in this diagram is the business model of the research house.

Diagram 3.1



3.4 The first area of committee interest was the relationship between research houses and financial planners and financial advisers, and between research houses and fund managers. Several factors led to a focus on the nature of these interactions.

3.5 Firstly, in its report into Trio, the committee had found an expectation gap around the perceived role of research houses and research reports including the claims made in a research report and the basis for their formation:

> there is a lack of understanding as to the claims made in the reports issued by research houses and in particular, whether the data provided by the responsible entity upon which these reports are based has been verified. There is also some confusion as to whether the ratings are intended as an indicator of future performance, or simply an assessment of past performance.[1]

3.6 Secondly, as noted in chapter 2, the different research houses operate different business models, with fees and payments to research houses flowing from the financial planning and advisory sector, and also in some cases, from the fund managers whose funds are being rated. Given concerns about the potential impact of conflicts of interest on research quality, the committee wanted to understand how the different business models worked and how the conflicts of interest that emerge under those models are either managed or avoided.

3.7 Thirdly, in November 2011, the Australian Securities and Investments Commission (ASIC) consulted with the research houses, and in December 2012 it released a regulatory guide for research houses. The roundtable gave the committee the opportunity to gain the insight of the research house sector into the operation of the new guidelines.

3.8 Fourthly, following an observation in the 'Bridging the Gap' session at the ASIC Annual Forum in March 2013 about the influence that research houses exercise in the system, the committee wanted some perspectives on the impact that a rating has on the flow of new capital into a recommended fund.

3.9 And fifthly, following criticism of research houses during this session, the committee was keen to question research houses about their accountability within the financial services system.

What does a rating mean?

3.10 The committee report into Trio identified confusion around what a rating actually means. The committee asked Lonsec Research Pty Ltd (Lonsec) to clarify the meaning of a rating, the basis for its formation, whether it is an indicator of future performance, and the nature of quantitative and qualitative investment research.

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1 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 123.

3.11 Lonsec told the committee that financial product ratings and research opinions constitute general advice that is supplied to advice-giving intermediaries, such as financial planners and financial planners. It noted that ratings should not be the sole basis of financial advice:

> Each of the five research houses in Australia ascribe ratings to unlisted financial products. The universe of available financial product is large (approximately 4000 managed funds at the 'headline' or 'parent' level, and approximately 12,000 funds once tax structures and platforms variants are accounted for). Each research house identifies a significantly smaller subset of this universe to submit to their proprietary research processes and the result is typically a research report (or reports) containing factual information, opinion, and an overall investment rating.
>
> Each research house has a different basis for, and therefore definition of, its ratings. This is one of the key points ASIC identified in RG79 – that users of research needed to be aware of, and understand, the varying meanings attached to ratings across the research house industry. Generally speaking though the following statements can be made:
>
> Financial product ratings and accompanying research opinions are primarily supplied to financial advisers, as opposed to end investors. They therefore only constitute general advice.
>
> A key part of research house ratings processes is the categorisation of financial products in order to form peer groups.
>
> Research house ratings are descriptors or labels which reflect the relative merits of financial products, as determined by each research house’s disclosed ratings process, and consistent with the stated ratings definitions. Ratings are typically scale based and therefore relative to other ratings of like financial products (ie x stars out of 5, A-B-C-D, Highly Recommended, Recommended, Investment Grade etc). Ratings definitions are typically displayed within the research report itself, whereas detailed explanations of research processes are typically made available to users of research via research house subscriber websites.
>
> Research houses do not typically publish their ratings without accompanying research. Lonsec believes (and we believe that all research houses are of the same view) that financial product ratings require context and guidance (within the bounds of general advice) in order to be used appropriately. A positive financial product rating can be broadly interpreted as a professional opinion that a financial product provider has the requisite investment people and investment processes in place to achieve their stated product objectives in the future over an appropriate investment time horizon (naturally, the rating is not a guarantee). A rating (in isolation from its supporting research) does not tell an investor who the financial product is or isn’t suitable for, how to use the financial product, how the financial product should 'behave' in certain market environments, or what key risks should be considered prior to investing into the financial product. Within the bounds of general advice, a good research report will provide general guidance and general opinion to assist financial advisers in forming their

> professional views on these aspects. In summary, Lonsec contends that financial product ratings should form one part of an adviser's overall due diligence process and should not be used as the sole basis for recommending a financial product.
>
> In Australia, financial product ratings take into account varying degrees of historical quantitative information (return, risk etc) but are primarily determined (in a peer reviewed, systematic fashion) by professional qualitative judgement (subjective opinion). Lonsec understands that an exception to this general statement is the Morningstar 'Star' rating system, which we believe to be completely quantitative.[2]

3.12 While ratings and research were not intended 'to be a predictor of future market performance', Lonsec noted that qualitatively determined financial product ratings were 'intended to be forward-looking':

> Research houses will generally have a well defined research process that outlines the key criteria for determining a financial product rating. Typically, these processes will have elements of qualitative and quantitative based analysis. In Lonsec's case the research process is skewed to qualitative research as Lonsec believes that qualitative based research is a better indicator of whether a financial product provider has the requisite people and processes in place to meet their stated product objectives in the future. Lonsec believes that while quantitative analysis is useful in assessing a financial product provider's historical performance and risk attributes, it is a poor indicator of a financial product provider's ability to meet their objectives in the future.[3]

3.13 Lonsec stated that qualitative assessments of investment people and investment processes accounted for approximately 80 per cent of the rating that it would give to mainstream asset classes, while quantitative factors such as emphasis on the returns, risk and consistency of the financial product would account for 20 per cent of the rating.

Quality and type of investment research in Australia

3.14 The type of qualitative investment research that features strongly in Australia is more expensive to produce than quantitative research. Lonsec pointed out that compared to the United States (US), the Australian market is highly geared towards qualitative research:

> the Australian research house sector conducts its managed funds research in a predominantly qualitative manner. Certain other markets in the world, most notably the US, are dominated by research houses that operate primarily quantitative research and ratings processes. Quantitative processes are mechanised, driven primarily by technology and are scalable.

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2 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

3 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

> In contrast, qualitative processes rely far more heavily on people, are therefore more expensive to operate and are far less scalable unless revenue is directly linked to research volume.[4]

3.15 According to interviews conducted by Mr Jason Spits, a freelance journalist who contributes to the publication *Money Management*, overseas-based fund managers offering investment products into the Australian market are:

> often surprised by the depth and rigour local research houses bring to their work in assessing funds, as well as the necessity of having products rated before releasing them to the financial planners.[5]

3.16 Mr Giles Gunesekara, Head of Third Party Sales at Principal Global Investors, observes that the quality of research in Australia is higher than elsewhere:

> having a tight ratings market has been a contributor to the level of sophistication of the Australian market, with managers from the UK and US commenting to us that the research process here is at a higher level than any other country.[6]

3.17 The argument has been made by Mr Tim Murphy, co-Head of Fund Research at Morningstar that the rigour and independence of the investment research produced by the research sector in Australia has industry-wide benefits because:

> there were less product blow-ups here than in the US and Europe during and since the global financial crisis. On that score product providers, regulators, planners and consumers have been well served by a robust research house market.[7]

Research houses as gatekeepers

3.18 Lonsec explained that elements of the gatekeeper function in the financial services system have been outsourced to the private sector by the regulator. Research houses therefore perform a gatekeeper role that includes assessing products for risks and fitness for purpose:

> In contrast to a number of other industries governed by consumer protection legislation, the wealth management industry in Australia has historically

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4 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

5 Jason Spits, 'Fund managers and research houses—a cold war thaw?', *Money Management*¸ 5 July 2013, http://www.moneymanagement.com.au/analysis/rate-the-raters/fund-managers-and-research-houses-a-cold-war-thaw (accessed 15 July 2013).

6 Giles Gunesekara, Head, Third Party Sales, Principal Global Investors, cited in Jason Spits, 'Fund managers and research houses—a cold war thaw?', *Money Management*¸ 5 July 2013.

7 Tim Murphy, co-head of fund research, Morningstar, cited in Jason Spits, 'Research houses stand their ground', *Money Management*¸ 5 July 2013, http://www.moneymanagement.com.au/analysis/rate-the-raters/research-houses-stand-their-ground (accessed 15 July 2013).

> been lightly regulated. Political acceptance of popular economic theory currently dictates low intervention in financial markets in the name of market efficiency; this is not a peculiarly Australian phenomenon. Consequently, the powers of regulatory authorities (such as ASIC) to act as broad ranging 'gatekeepers' are relatively limited. Parts of the gatekeeper function are, by necessity, 'outsourced' from regulators to free market participants and the regulator's role becomes one of 'holding gatekeepers to account' for those functions. In more heavily legislated industries, regulators may undertake a wider range of gatekeeping activities including the assessment of product 'safety' (risks) and 'efficacy' (fitness for purpose). In the wealth management industry, this role is performed by research houses.[8]

The role of research houses and investment research and expectation gaps

3.19 Mr Richard Everingham, General Manager of Strategy and Development at Lonsec, stated that the role of a research house is 'to provide independent opinion on the quality of investment products in the marketplace'.[9] He noted that Lonsec achieved this by:

> issuing investment product ratings with supporting investment product research. Lonsec's ratings are determined on the basis of our level of conviction that the investment products can achieve their objectives and on our opinion of the relative attractiveness of the products versus their peers.[10]

3.20 Mr Everingham differentiated the role of the research house from that of a financial planner by drawing attention to the general nature of advice provided by research houses, and contrasting this with the client-specific advice produced by financial planners and advisers:

> Research houses also produce opinion on the nature of investment products, guidance on how to use them and what features and attributes they may have which may assist in determining investor suitability. However, this advice and opinion must by law be general in nature. We do not know the end investor and, as such, we cannot provide personal advice. This is the role of a financial adviser.[11]

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8 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [3].

9 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 6.

10 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 6.

11 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 6.

3.21 Lonsec claimed that some financial planners have misplaced expectations about the nature and use of investment research, and the responsibilities of the various players in the financial advice chain. In arguing the need for greater professionalism in some parts of the financial planning and financial advice sector, Lonsec drew an analogy between the role and responsibility of a medical practitioner in the health system and the role and responsibility of a financial planner or financial adviser in the financial services system:

> To illustrate this point, Lonsec draws a parallel between the medical 'advice chain' looking after an individual's 'physical health' and the financial 'advice chain', looking after an individual's 'financial health' (the latter expressed in brackets below).
>
> Few would argue that a doctor (advice giving intermediary) who prescribes an approved (rated) drug (product) to a patient (client) without first assessing whether a) it is the right drug for the right patient and the patient's current circumstances (client suitability and client best interests), b) understanding what dosage is appropriate and when to take the drug (how to use the product, including portfolio weighting) and what interactions the drug may have with others already being taken (overall portfolio impact and correlations) has failed to discharge their duty of care (common law fiduciary duty, statutory 'best interests' duty) to their patient. The regulator (ASIC), the pharmaceutical company (financial product issuer) and independent advice giving bodies such as the National Prescribing Service - NPS (research houses) may provide information, education, and guidance which speak to these aspects, but ultimately the doctor must take this generalised guidance (general advice) and apply their education, training and experience to each patient's specific circumstance to make a holistically tailored recommendation (translate the general advice to 'personal advice').
>
> Despite this clarity in the medical advice chain, a significant number of participants in the financial advice chain, including financial planning industry associations, still argue and debate the respective roles of ASIC, research houses and financial planners. Research houses encounter misunderstanding, misconception and, in some cases, clear abrogation of responsibility from a subset of financial planners with respect to what constitutes investment research, how it should be used, its limitations and the respective responsibilities of all parties in the advice process.
>
> Specifically, research houses continue to encounter 'expectations overreach' from a subset of financial planners in the following areas:
>
> - What a rating is and is not and the degree to which it can be relied upon;
> - An expectation that it is the role of investment research to accurately and consistently predict, thus avoid, financial product failure;
> - An expectation that well rated financial products will consistently outperform their benchmarks over 'short term' periods;
> - An expectation that well rated financial products will offer 'downside defensiveness' when markets fall; and

- An expectation that all well rated financial products are suitable for all clients.[12]

Research house business models and conflicts of interest

3.22 Chapter 2 described the various research house revenue models including subscription fees paid by financial planners and financial advisers ('downstream' payments) and direct and indirect payments from fund managers ('upstream' payments).

3.23 A conflict of interest arises in the research function when a fund manager pays a research house (direct 'upstream' payment) to conduct research and produce a rating on one of their funds. However, depending on the business model, there is a range of indirect as well as direct payments that flow between fund managers and research houses.

3.24 In its submission to the Trio inquiry in September 2011, ASIC suggested that the government might consider banning payments made by fund managers and product issuers to research houses.[13] Yet there is no mention of this suggestion in the Regulatory Guide issued by ASIC in December 2012.[14] The committee was therefore concerned to understand the suitability and sustainability of the various business models used by the research houses, and the adequacy of the arrangements for managing conflicts of interest.

3.25 Lonsec argued that the business models operated by the research houses are a result of the financial planning industry being unable or unwilling to pay the research house sector for the full cost of producing investment research. Because of the cost sensitivity of the end-user, Lonsec claimed that 'the entire research house sector provides a materially discounted service to the financial planning industry'.[15]

3.26 As a consequence, Lonsec stated that 'a stand-alone, user pays research subscription business model is currently economically unviable',[16] and therefore some combination of payments from the issuers of financial products or cross-subsidization from other parts of the business is unavoidable:

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12 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, pp [5–6].

13 Australian Securities and Investments Commission, *Submission 51*, pp 83–84, Inquiry into the collapse of Trio Capital Limited, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

14 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012.

15 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [3].

16 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [5].

> To ensure a sustainable business model, **all** research houses cross subsidise the cost of investment research production through accepting some combination of payments from financial product issuers, be they direct or indirect, and/or the operation of one or multiple ancillary business units (emphasis original).[17]

3.27 Lonsec pointed out that most users of investment research require 'high quality, timely research with sufficient breadth to provide an appropriate range of financial products for Approved Product Lists'. According to Lonsec, however, 'these three needs (*quality, volume, timeliness*) *are operationally conflicting and cannot all be individually optimised*' (emphasis original).[18] Given the operational constraints in the research market at present, Lonsec argued that the costs involved in producing enough high quality research are best met by direct payments from product issuers:

> Conducting sufficient volume of high quality *qualitative* research in a timely manner is very resource intensive and therefore very costly, and inherently difficult to scale up unless revenue is directly linked to research volume (as it is under a 'pay for research' business model) (emphasis original).[19]

3.28 Mr Everingham outlined the conflicts of interest that arise from the choices facing research houses:

> Research houses have a choice. They can adopt a model which is funded, in part at least, by the product issuer. Alternatively, they can cross-subsidise their research activities from other business units. These indirect conflicts generally arise through the activities of the other ancillary business units—not always, but generally. We believe—and we submitted this to ASIC in the RG79 process—that these types of indirect conflicts are potentially more problematic, because they are generally not disclosed. They are generally more multidimensional and they are generally not alerted to the end investor. The direct conflict in the pay-for-research model, on the other hand, is apparent and is disclosed. For example, the first line of our disclosure in our research report mentions that we are paid for the research process by the product issuer.[20]

3.29 Lonsec concluded that:

> the interests of all stakeholders - users of investment research (financial planners), consumers, research houses, Government and ASIC - are aligned

17 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [3].

18 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [4].

19 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [5].

20 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, pp 10–11.

> and best served through the existence of a diverse, competitive and commercially sustainable research house segment.[21]

3.30 The implication of this argument is that if ASIC moved to ban the pay-for-ratings model, the sustainability of a substantial part of the research sector would be at risk and competition in the research house sector could be diminished.

3.31 Mr Mark Thomas, Director and Chief Executive Officer of van Eyk Research Pty Ltd, pointed out that the van Eyk subscriber-based business model represented the investor and that van Eyk research can only be accessed by those subscribers that pay for it ('downstream' subscription payments from financial planners and financial advisers).[22]

3.32 Mr Thomas distinguished between indirect payments related to use of the ratings material and the acceptance of payments to advertise in a research house magazine or attend a research house conference. He also noted that van Eyk discloses any indirect payments that it receives:

> I do believe that there is indirect and indirect. You need to look at indirect payments which relate to the process of using the ratings material. Some houses use a royalty system where they are paid by the issuer for the use of the rating. We operate a model which does not employ those sorts of indirect payments. We do have a magazine which has advertising in it. We do have, in that magazine, advertisements from fund managers who we have rated well—but who have also been rated well by our competitors. They put those badges of honour on their advertisements as well. But that is a commercial decision after the event—after the ratings process.
>
> […]
>
> The indirect side of it—yes, it is disclosed. We run a magazine. We have a conference. People pay to attend. They may also invite people to come along as their guest. But that is, again, an arm's-length piece.

3.33 Furthermore, Mr Thomas observed that in his consultation with ASIC, the key criteria that concerned ASIC was not necessarily the research house business model, but rather the research outcome, and in particular that the research results were free from bias. Mr Thomas pointed out that the research results produced by van Eyk illustrated his point:

> As it turns out, we recommend less than half of the investments we review and in our view that is an unbiased outcome.[23]

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21 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [1].

22 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 7.

23 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 7.

3.34 The contrast between the results generated under the van Eyk model and those generated under the pay-for-ratings model (that is, paid for by the fund manager or product issuer) were discussed. Mr Thomas argued that the higher level of recommendations given under the pay-for-ratings model indicated that the gatekeeper role of the research houses that used the pay-for-ratings model was being compromised:

> The point I would bring this back to is that it is really about results and independence around those results. When you look at a universe of investments, you need to make sure that you are assessing it on merit. In some cases you will recommend more on merit and in some cases you will recommend less on merit. But ultimately you need to make a decision and you need to provide that advice independently to your users. If you are providing advice and granting a positive recommendation to too many things, clearly you are not being a gatekeeper—at least not in my mind. We drew attention in our submissions to ASIC to the unbiased component. As part of that, we felt that there was clearly a need for higher levels of regulation in the payment-for-ratings process—because, on the analysis we had seen, there was a greater level of recommendation occurring there than on the other side, which is a purely subscription based mechanism where we are just providing advice to the investor and charging them for that.
>
> We recommended a couple of options there, which ASIC chose not to take notice of. One was a quota system of higher regulation if that situation were to occur.[24]

3.35 This perspective was disputed by Mr Everingham who argued that because Lonsec rated less than 20 per cent of the total number of funds in the market (in other words, it screened out most of the funds), the results would necessarily include a higher proportion of positive ratings:

> I think to complete that information we would like to say that the spread of ratings under a pay-for-research model is necessarily skewed to the right of the curve, if you like, because of the number of products that have been screened out or not rated. For example, Lonsec, which do operate under this research model, currently rate around 720 headline funds. These permeate through different tax structures and platforms and so forth, but it is essentially 720 funds. There are about 4,000 in the universe of the equivalent total headline funds. So you can see from that that we do not rate the vast a majority of funds. We have significant screening, significant filtering, and we would actually contend that the proposition that pay-for-research leads to a skewing of the ratings that are a positive is actually incorrect.[25]

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24 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 11.

25 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 11.

Perspectives on conducting internal research versus purchasing external research

3.36 There is a trend towards internal or in-house investment research being conducted by financial advisory businesses. Internal research is typically used to complement the external research that financial advisory businesses source from research houses.

3.37 Mr Tony Graham, Executive Director and Head of Macquarie Adviser Services at Macquarie Group, noted that Macquarie Group operated an in-house research function in partnership with external research houses.[26] Macquarie Group emphasised that it always sought independent external research on any managed fund:

> In Macquarie's financial advising business, a managed fund will only be considered for the investment menu if supported by at least one independent research report e.g. Mercer, Morningstar, van Eyk, Zenith, and Lonsec. If one doesn't exist and we feel there is a compelling reason to consider a fund, then we undertake our own in-house research. We may incorporate a form of research from the manager itself, but not solely rely on it.[27]

3.38 Mr Graham said that Macquarie Group was mindful of the business model used by the research houses, but that the more important criteria for Macquarie Group in choosing a research house for a particular piece of work was 'the expertise of the research manager. We are looking at the next layer down—their track record and depth of expertise in a particular area to help inform us even more'.[28]

3.39 Macquarie Group outlined the criteria that it uses to critically evaluate a research house report:

> Macquarie firstly considers the research house that is providing the report, e.g.:
>
> - its reputation;
> - whether the research report is paid for by fund manager or subscribers;
> - the expertise of the research house in the specific area.
>
> Macquarie's advisers next consider the report itself and the level of detail provided on matters such as:
>
> - fund personnel;
> - history of the fund;
> - performance of the fund under different market conditions;

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26 Mr Tony Graham, Executive Director, Macquarie Group Ltd, *Proof Committee Hansard*, 21 June 2013, p. 8.

27 Macquarie Group Ltd, correspondence to the committee, 19 July 2013.

28 Mr Tony Graham, Executive Director, Macquarie Group Ltd, *Proof Committee Hansard*, 21 June 2013, pp 8–9.

- investment process;
- decision making capability;
- experience of staff;
- funds under management (FUM);
- ownership structure;
- fees; and
- risks.

> Macquarie also considers the resources available to the research house, both personnel and analytical tools.
>
> We acknowledge that many financial advisers may only use one research house for a view on funds, given the high cost of having multiple providers.[29]

3.40 Macquarie Group also outlined the way in which a fund or product was added to the approved product list:

> Macquarie Advisers do not determine the funds or products which are available on our Investment and Product Menu, they are assessed by our Unlisted Investment Committee. In order for a fund or product to be proposed for consideration for inclusion to the menu (in the majority of cases), an investment grade rating by an external research house is required, as are other operational criteria. Failing that, or in the event of any change in rating or other criteria, supplementary research is undertaken by the MPW Research team and submitted to the Committee.[30]

3.41 Mr Royce Brennan, General Manager of Risk at BT Financial Group, said that from a trustee's perspective, research houses had expertise in different areas and that an important determinant in selecting a research house was the degree of expertise that the research house had in the relevant area. He noted that BT Financial Group had their own research internal research capability which they used to complement the work of the external research houses.[31]

3.42 BT Financial Group explained how their in-house research teams function:

> BT Financial Group is supported by two key in-house research teams, focusing on Advice and Fund Manager Governance.

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29 Macquarie Group Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. 2.

30 Macquarie Group Ltd, answer to question on notice, 28 June 2013 (received 19 July 2013), p. [2].

31 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 9.

> *Advice*
>
> The Advice in-house research team is responsible for the review of investments to formulate an Approved Products List which provides guidance to financial planners when providing advice to customers.
>
> The team undertakes a formal research process to identify best of breed investment opportunities across all asset classes and product types. Investments are reviewed and monitored on a regular basis. We note that the in-house research team is required to assess internally and externally sourced products in the same way in its research assessment.
>
> The Advice in-house research teams have access to external research resources including Zenith Investment Partners, Chant West, JP Morgan, Bloomberg and Morningstar as inputs into the research process.
>
> For the Advice business, external research is also used to supplement broader investment choice for our external adviser networks.
>
> 1. *Fund Manager Governance*
>
> The Fund Manager Governance in-house research team is responsible for monitoring and oversight of all investments across our platform, superannuation and investment businesses.
>
> The team provides analysis and recommendations in relation to selecting investment options and appointing fund managers, as well as oversight and monitoring of investment options, for the platforms, superannuation and investment businesses.
>
> As well as undertaking its own due diligence on investment managers, the team has access to external research resources including Lonsec, Zenith Investment Partners, Chant West, van Eyk and Morningstar as inputs into the research process.
>
> One of the key functions of both in-house research teams is to support the delivery of quality outcomes to clients. We believe an in-house research function allows greater support that is tailored to the needs of our financial planning network and allows better oversight of the quality of the research conducted.[32]

3.43 Importantly, BT Financial Group pointed out that they do not offer incentives to their internal research teams to recommend that any particular product or asset class be placed on an approved product list.[33]

3.44 In explaining its approach to conflicts of interest in the research sector, Dixon Advisory made the point that external research is just one of many inputs into its investment advice:

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32 BT Financial Group, answer to question on notice, 28 June 2013 (received 12 July 2013), p. 4.

33 BT Financial Group, answer to question on notice, 28 June 2013 (received 12 July 2013), p. 3.

> Dixon Advisory understands that most major research houses receive direct and/or indirect income that creates a perceived or actual conflict of interest. We prefer to source research from a provider that has either a clearly articulated business model or adequate disclosures of the conflicts so that we can assess the severity of the conflict and evaluate the research with this in mind. More importantly, we try to mitigate the impact conflicts of interest may have by only using external research as one of the many sources of information we use when considering an investment. We don't believe it is appropriate to use external research as the sole decision making criteria when recommending investments. [34]

3.45 Dixon Advisory performs some investment research in-house and noted that this is a trend within the advisory sector. It cited better focus and 'transparency over the quality' as an advantage,[35] but noted that in-house research can increase business costs and that 'it is not cost effective for a firm of our size to hire a full time research team to conduct all of the research our advisors and clients require'.[36]

3.46 Other factors that Dixon Advisory consider in making a decision about whether to purchase external research are the asset class or product type in question and the availability of external research:

> In practice this may mean that where we have a significant focus on an asset class or product type we will look to add capabilities to our firm so that we can conduct this research in house. For asset classes and product types that we only see as a small part of a diversified portfolio or that are extensively well covered by external research we will generally use external research.[37]

3.47 However, Dixon Advisory also recognise a dilemma in that the growing trend to in-house research could damage the business models of the research houses, which would have negative consequences for the advisory sector:

> the research houses need to remain profitable and limiting their revenue streams could lead to a scarcity of high quality affordable research – especially on smaller funds. This would be a counterproductive outcome.[38]

3.48 Dixon Advisory also commented on the claims made by Lonsec that the research houses provided a 'materially discounted service to the financial planning industry', noting that:

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34 Dixon Advisory, answer to question on notice, 28 June 2013 (received 12 July 2013).

35 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [3].

36 Dixon Advisory, answer to question on notice, 28 June 2013 (received 12 July 2013).

37 Dixon Advisory, answer to question on notice, 28 June 2013 (received 12 July 2013).

38 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [3].

> If there was high quality independent research available in Australia that not only satisfied compliance requirements but also provided unique investment thesis, we would be willing to pay an appropriate price for this research. We have shown this by subscribing to international research on macro economic views from companies that have a pure independent business model.
>
> […]
>
> Ultimately it is up to research houses to prove to investors and the financial advising sector that the research that they sell will provide additional insights not available elsewhere. Until they can justify that the quality of their research is worth the cost they will not be able to charge the full cost of production.[39]

3.49 Lonsec said that the size of the financial advice licensee typically influences how they use internal and external research:

> Research from research houses is used by financial advisers in many ways, ranging from being 'hard coded' into the licensee's compliance framework to being just one input amongst a number in an overall internal licensee research effort. An example of the first approach, which Lonsec typically observes in smaller financial advisory practices, is where a licensee decrees that the Approved Product List (APL) comprises only Lonsec financial products rated Recommended or Highly Recommended (Lonsec's two highest ratings). Such licensees may also decree that the Lonsec's core 'model portfolios' are adopted as the licensee's 'model portfolios'.
>
> An example at the other end of the spectrum, which Lonsec typically sees adopted within the largest institutional advice businesses, is where research house research and ratings are used as a starting point and a back up to the internal research effort. These licensees typically subscribe to research from multiple external research houses. The in-house research team then does 'overlay' and 'gap' research, typically in areas of heightened end investor demand, heightened risk, heightened financial product complexity, or areas of perceived weakness in the external provider's capabilities. The in-house team prescribe their own ratings, select their own APL, and create their own model portfolios (often in conjunction with consulting input from a research house). The external research house research and ratings are not 'hard coded' into the licensee's compliance framework.

3.50 The advantages and disadvantages of the two approaches to using external research were outlined by Lonsec:

> The primary advantages of the former approach are cost savings and advice efficiency – essentially the licensee has outsourced the bulk of the financial product research process to a third party. A second advantage is that the size of the APL tends to be relatively large based on this type of blunt construction criteria and therefore there are fewer transition issues to

39 Dixon Advisory, *answer to question on notice*, 28 June 2013 (received 12 July 2013).

> consider when new financial advisers join the group (new financial advisers often bring with them clients who are invested into financial products that are not on the APL of the new licensee). A third advantage is APLs will be manufacturer agnostic and independent.
>
> The primary disadvantages of this approach are that the licensee has not refined the APL or model portfolios to suit their specific client base and the relatively large APL creates a relatively large compliance burden (and risk). A secondary disadvantage lies in the aforementioned over-reliance on ratings relative to other features and benefits of potential value to clients which may exist in lesser rated financial products. For example there may be 'Investment Grade' (this is the Lonsec rating below 'Recommended') financial products excluded from the APL which have better tax efficiency at certain marginal tax rates or better insurance features (for superannuation financial products) than the higher rated financial products included on the APL. Underlying clients of the financial advisers within this licensee will not have access to these financial products.
>
> The chief advantage of the second approach is greater overall due diligence and governance, and a more focused APL to meet the needs of the main end client types or end client scenarios which prevail in that group. A key disadvantage of this approach is cost – typically only the institutional licensees and the larger mid tier licensees operate in-house research teams in excess of 1 person, therefore the capacity to undertake meaningful 'overlay' or 'gap' research is limited. A secondary potential disadvantage is the possibility of restricted access of non-aligned financial product to the marketplace. Institutional advisory practices are vertically integrated and, subject to appropriate internal governance, 'group' or 'aligned' financial product may in some instances dominate certain sectors within the APL. Given APLs are often 'capped' in total size (to reduce compliance burden and maximise oversight and control) this can have the effect of blocking out 'non aligned' financial product from these APLs within certain sectors.

3.51 Lonsec concluded that investors benefit most when there is synergy between internal and external research teams:

> In Lonsec's experience the most effective outcomes for end investors occur when external and internal research teams work in tandem and the internal teams leverage the full range of external research services, such as investment consulting (for APL and model portfolio construction, and investment committee representation) and the option of direct access to Lonsec's analysts (to discuss financial products).[40]

Quality of financial advice and relationships that financial advisers have with research houses and fund managers

3.52 In its 2012 shadow shopping report on the quality of personal retirement advice provided by financial advisers, ASIC found that:

40 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

- 39 per cent of the advice examples were poor;
- 58 per cent of the advice examples were adequate; and
- 3 per cent of the advice examples were good quality.[41]

3.53 Lonsec was also critical of the professional standards within segments of the financial planning industry, arguing that the industry in general made poor use of investment research, including failing to adequately match products with client needs:

> The first thing I will say is that by necessity that is a generalised statement. Of course there are many good financial planners. The issue that the industry has is that there are not enough of them. If you look at the ASIC shadow-shopping survey, from the last results five per cent or so were deemed good or better in terms of plans audited. In what we see, the use of research by the typical or average planner can perhaps be best described as a compliance tick or something akin to an insurance policy. It is purchased on price upfront and when something goes wrong the features of what you have purchased are closely scrutinised.
>
> In terms of the rating, we do our best in our reports to give guidance on how products should be used. We clearly make it known that a highly rated product is not suitable for everybody and we see it as the role of the financial planner to marry the product to the right client—to determine product suitability. We are making a statement about the outright quality of the product. The planner must sit in the middle between the product and the investor and determine whether or not it is the right fit. We take calls and get feedback. When you have a market downturn as severe as during the GFC you cop a lot of flack. These are points we make in our paper. They are a summary of the flack we have copped post GFC.[42]

3.54 Mr Graham said it would be 'very risky' for a financial adviser not to get independent research on a fund and that the common industry practice was to have independent research to support the advice that would be given to a client regarding a particular fund.[43] He noted that the current industry standard is for a financial planner or financial adviser to work from an approved product list. The approved product list is constructed based on independent research, which may be internal research and/or external research from a research house. Typically, an adviser may prefer to recommend managed funds, or direct equities, or there may be model portfolio

41 Australian Securities and Investments Commission, *Shadow shopping study of retirement advice*, Report No. 279, March 2012, p. 8, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep279-published-27-March-2012.pdf/$file/rep279-published-27-March-2012.pdf (accessed 2 July 2013).

42 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 16.

43 Mr Tony Graham, Executive Director, Macquarie Group Ltd, *Proof Committee Hansard*, 21 June 2013, p. 15.

structures from which an adviser may choose.[44] The model portfolios form the basis of the statement of advice.

3.55 However, Mr Everingham was critical of the minimal extent to which the research produced by research houses ends up in the statement of advice produced by a financial planner:

> The degree to which a research house's research makes it to the end consumer is dependent upon what the financial adviser decides to pass through. Our experience from our organisation, given the sorts of hit counts and so forth we can generate from our website, is that only the most rudimentary short-form pieces of research are making it into statement of advice plans that the financial planners approve.[45]

3.56 A key determinant of the quality of financial advice is the extent to which a financial planner or financial adviser understands the needs of their clients and carefully explain their recommendations. Dixon Advisory emphasised that:

> It is the role of advisers to understand what factors are important to their clients when making recommendations. Advisers in general can assist to clearly explain their role and their process for selecting investments to investors so that the opportunity for expectation gaps to arise is minimised.[46]

3.57 Part of the advice relationship with investors involves identifying the probability of various risks occurring:

> All investors (from institutional through to retail) are exposed to virtually limitless risk. This means that an important consideration is the probability of the risk eventuating. While investors need to be aware of the risks they are facing it is not helpful to highlight all risks equally as this detracts from the fact that the probability of each risk occurring is different.[47]

3.58 Ultimately, however, Dixon Advisory said that investors must take responsibility for the risks they are taking on by 'informing themselves using the information provided to them by advisers and other gatekeepers'.[48]

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44 Mr Tony Graham, Executive Director, Macquarie Group Ltd, *Proof Committee Hansard*, 21 June 2013, p. 18.

45 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 16; see also Lonsec Research Pty Ltd, answer to question on notice No. 6, 28 June 2013 (received 12 July 2013).

46 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [2].

47 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [2].

48 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [2].

3.59 The Future of Financial Advice (FOFA) reforms place a statutory onus on financial planners and advisers to put the best interests of their clients first and to avoid conflicted remuneration. However, in the wake of the scandal involving the Commonwealth Bank and Commonwealth Financial Planning,[49] concerns have been aired in the media that when a financial institution creates financial products and also controls a financial advice network, a situation could still arise where the commercial interests of the licensee conflicts with the financial adviser's best interest obligation to their client.[50]

3.60 The committee put these concerns to both BT Financial Group and Macquarie Group. BT Financial Group replied that:

> As part of the recent Future of Financial Advice (FOFA) reforms, which we support, we have implemented new 'best interests' requirements to further support planners in demonstrating they have met their best interests obligations to customers.
>
> We have strong and well-established risk management and governance frameworks. These establish clear protocols for how we operate as a business, including the products we offer to our customers whether through our Approved Product Lists or otherwise. We accept that conflicts of interest may arise from time to time in the normal course of business. However, we are confident that we have appropriate processes and protocols in place for managing any such conflicts.
>
> In addition:
>
> - Our advisers are not restricted to recommending our products, and they can and do advise on and recommend other products to our customers.
> - We are continually improving our products to ensure they meet the needs of our customers.
> - We have strong controls in place to ensure that our advisers only recommend products when it is in the best interests of our customers. Our advisers are required to place customer interests above their own

49 Adele Ferguson and Chris Vedelago, 'Profit above all else: how CBA lost savings and hid its tracks', Weekend Business, *Sydney Morning Herald*, 1 June 2013, pp 8–10;
Adele Ferguson and Chris Vedelago, 'The boiler room—How the Commonwealth Bank's financial planners partied while their clients went bust', Business News, *Sydney Morning Herald*, 22 June 2013, pp 1 and 6–7.

50 Leng Yeow, 'This advice will remain unchanged', *Australian Financial Review*, 29 June 2013, p. 17;
David Potts, 'A new year's fizzer', *The Age*, 26 June 2013, http://www.theage.com.au/money/planning/a-new-years-fizzer-20130625-2otfr.html (accessed 26 June 2013);
The Sydney Morning Herald, Editorial, 'Legal reforms will not let ASIC off the hook', 22 June 2013, p.13.

> and above those of the BT Financial Group and the Westpac Group, and there are consequences for our advisers if they do not do this.[51]

3.61 The committee also questioned BT Financial Group about whether its financial advisers were subject to sales targets, and any tensions that may exist for its financial advisers in meeting the best interests of their clients. BT Financial Group stated that:

> We do not employ advisers to sell products. We employ advisers to provide financial advice and to help meet the financial needs of our customers.
>
> We believe in the value of financial advice and we provide quality advice to customers in a strong and sustainable model.
>
> We do not impose product sales targets on any of our financial advisers.
>
> In the adviser channels we own (i.e. Securitor and BT Select) we work with financial adviser practices by helping them to attract and service customers but we do not specify sales or revenue targets for these practices or their financial advisers.
>
> The salaried adviser channels (e.g. Westpac Financial Planning and St.George Financial Planning) have revenue targets, and planners participate in a bonus scheme. All revenue (initial and ongoing), and all asset categories or products (ie. managed funds, direct equities, etc), are treated equally under this scheme. Salaried advisers are only eligible to participate in the bonus scheme if they have met certain requirements within a particular period (including feedback from customers and meeting compliance requirements). There are no sales targets relating to particular products, Westpac Group products or asset classes.
>
> We take our responsibilities seriously in supporting quality advice to customers. We require planners and management to comply with the law as well as applicable regulations and company policies. In particular, we require our planners to comply with best interest obligations and consequences of failing to comply are serious and can include withholding or cancelling a planner's bonus, performance management and, potentially, termination. We carry out regular auditing of planners. We also assess and review our obligations, key controls, including our monitoring system, at least annually.[52]

3.62 Macquarie Group explained its use of financial advisers as follows:

> Macquarie employs Financial Advisers primarily to provide financial advice and other related services to clients. It is not for the purpose of selling financial products, whether they are created internally or externally.

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51 BT Financial Group, answer to question on notice, 28 June 2013 (received 12 July 2013), pp 1–2.

52 BT Financial Group, answer to question on notice, 28 June 2013 (received 12 July 2013), p. 2.

> Macquarie Advisers do not have sales targets. There are performance related remuneration criteria in place, however, these apply equally to Macquarie issued and externally issued products (i.e they do not incentivise Advisers to recommend Macquarie products, rather than external products).[53]

3.63 Macquarie Group noted that the FOFA legislation may encourage greater collaboration between financial advisers and product issuers as financial advisers will now be required to have a better understanding of the financial products that they recommend to their clients:

> FOFA may create an incentive for financial planners and financial advisers to work more closely with fund managers and product providers, as they would be keen to ensure that products are developed to meet the needs of their clients, in terms of features, benefits, services, etc, to ensure that they satisfy the best interest duty obligations.[54]

3.64 Mr Martin Codina, Director of Policy at the Financial Services Council, noted that in relation to approved product lists and statements of advice, FOFA will not only impact on financial advisers, but will also oblige licensees to help their authorised representatives to give advice in the best interest of the client, and that taken together, this would provide 'quite a robust framework'.[55]

3.65 The committee also asked ASIC to comment on a situation in which the financial product manufacturer and issuer also owns a financial advisory network, leading to a potential conflict between the commercial interest of the product manufacturer and the financial adviser's best interest obligation to its clients. ASIC responded:

> Section 961J [of the Corporations Act] requires that if a provider knows, or reasonably ought to know, that there is a conflict between the interests of the client and the interests of the provider or an associate or representative, the provider must give priority to the client's interests when giving advice. This obligation applies to advisers working for an advice network that is controlled by a financial institution.[56]

Relationships between research houses and fund managers

3.66 As noted earlier, fund managers in Australia regard it as necessary to have their products rated before releasing them to market. Mr Spits found that a diversity of

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53 Macquarie Group, answer to question on notice, 28 June 2013 (received 19 July 2013), p. [1].

54 Macquarie Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. 3.

55 Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, pp 18–19.

56 Australian Securities and Investments Commission, answer to question on notice, 27 June 2013 (received 23 July 2013), p. 6.

views on the relationship between research houses and fund managers exists, with some fund managers expressing the view that they are beholden to research houses that act solely in a gatekeeper role, whereas other fund managers see research houses in a much more collaborative way and view the financial planner as the ultimate gatekeeper. Fund managers that espouse a collaborative relationship note that feedback from research houses helps to increase the quality and sophistication of the financial product. Just as fund managers have different views on their relationships with research houses, there is a divergence of views among the research houses on their relationship with fund managers.[57]

3.67 van Eyk told the committee that it was not only financial advisors that practiced ratings-shopping, but there were also fund managers that would refuse a review because they feared a negative outcome. Mr Thomas said that research houses should disclose to ASIC those fund managers that refused to participate in a review:

> There are always going to be people who will shop something because they are looking for a different outcome. I would argue that it is not only the advisers who shop the ratings. The fund managers will also shop the ratings. We have had a number of fund managers refuse reviews from us because they knew they were not going to get a positive outcome. So they chose not to participate. That is something which RG 79 covers: we should disclose to ASIC which fund managers have refused to participate and for what sorts of reasons.[58]

Proposals for an industry body for the research house sector

3.68 Lonsec argued that an essential part of addressing the expectation gap between research houses and financial planners would be for the research house sector to form an industry body.[59]

3.69 In the wake of the Trio inquiry, Mr Everingham noted that the Financial Planning Association (FPA) had expressed a hostile stance towards research houses. He argued that one advantage of a research house industry body would be the ability to engage constructively with the FPA over points of difference 'and to try and come to some sort of consensus on the way forward'.[60]

3.70 Mr Thomas noted that the research houses do have 'informal gatherings where we have roundtables and discuss things' and that van Eyk 'would be favourable to

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57 Jason Spits, 'Fund managers and research houses—a cold war thaw?', *Money Management*¸ 5 July 2013.

58 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 17.

59 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 16.

60 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 17.

regular communication'. However, he questioned whether an industry body was necessary.[61]

3.71 The different perspectives expressed by Lonsec and van Eyk on the need for an industry body probably speak to the intense competition in the sector and the division within the industry over the pay-for-ratings business model that was identified in chapter 2.

Responses to criticism of research house accountability

3.72 In the 'Bridging the Gap' session at the ASIC Annual Forum in March 2013, there were pointed comments about the influence that research houses exercised in the system, and in particular the impact that a rating has on the flow of new capital into a recommended fund.

3.73 While acknowledging that ratings do influence the flow of funds, Lonsec stated that this was primarily a function of the 'one size fits all' approach adopted by many financial planning licensees:

> There is no doubt research house ratings have influence on fund flows but this, in Lonsec's opinion, is primarily a function of the over reliance on ratings in isolation from the supporting research. Licensees ultimately control their APLs and have the responsibility and the authority to make the final call on what financial products are made available to their financial advisers to recommend to their clients. Research houses do indeed perform a filtering, sorting and relative assessment function, as ultimately expressed through ratings, but the licensee is ultimately the true gatekeeper. To the degree that licensees choose to determine their APLs through selecting only the highest rated financial products from a research house, the influence of research houses is obviously significant. Lonsec would contend however that this approach has disadvantages and is likely to become less prevalent with FoFA reforms now enacted.[62]

3.74 Another criticism broached during the 'Bridging the Gap' session centred on an apparent lack of accountability to which research houses were subjected: that is, there was a feeling that research houses did not have enough 'skin in the game' because they were not sufficiently accountable to the end-users of their products when their research was poor.

3.75 When this criticism was put to Lonsec, it observed that the research sector was commercially competitive, and that aggregated ratings performance was a determining factor in whether a research house would obtain or retain a contact:

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61 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 17.

62 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

> Research houses have strong commercial incentives to produce high quality research and ascribe efficacious financial product ratings. Firstly, as Australian Financial Services Licence holders, research houses are regulated by ASIC and are subject to meeting the relevant standards and requirements of the Corporations Act. If a research house fails to meet any of the required standards or requirements significant reputational damage would result. Secondly, research houses operate within a very competitive commercial environment. The marketplace for research is therefore self regulating. Research houses are typically engaged on short term contracts and purchasers of research can and do quickly strip market share from participants that are perceived to be managing their conflicts poorly or producing compromised or poor quality research.
>
> On a fund by fund basis, to Lonsec's knowledge, there are no linkages between the accuracy of ratings and recommendations and research house compensation. On an aggregated basis there is however a link. It is a common practice for research houses to be asked by their clients (or prospective clients during tenders) for aggregated attribution analysis of the performance of their ratings and model portfolios. During tenders, research houses are also asked what their research and ratings history has been with various failed financial products. The practice is well established and in Lonsec's experience the track record of the research house in these aspects typically forms a material component of the overall decision to retain or hire.[63]

A proposed role for ASIC in closing the expectations gap between research houses and financial planners

3.76 Lonsec made suggestions that ASIC could undertake to help close the expectation gap between research houses and financial planners. However, they prefaced this by reiterating their view that the inappropriate use of ratings by financial planners was the root cause of the problem:

> at the heart of the 'expectations gap' is an over-emphasis and over-reliance on the use of ratings in isolation from supporting research, and in isolation from fully formed views (at the financial adviser level) about how a given financial product should be used and who it is and isn't appropriate for. This can lead to a 'one rating fits all' mentality.[64]

3.77 Lonsec also laid out how it saw the role of the research house in relation to the financial planner:

> In Lonsec's view, research houses have a major role to play in helping financial advisers to reach an understanding of the nature of financial products, a moderate role with respect to understanding the appropriate use

63 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

64 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

of financial products and a minor role with respect to identifying investor types and investor scenarios best suited to financial products.[65]

3.78 While acknowledging that the FOFA reforms and the guidance in RG 175 would improve the quality of financial advice and help close the expectations gap significantly, Lonsec outlined proposals for ASIC intervention:

> ASIC could provide the marketplace with a statement as to what financial product ratings are (and aren't) and what they can (and can't) be relied upon for (by users of research). In particular, Lonsec believes an expectations gap will remain as long ASIC remains silent on the expectations from some users of research: that
>
> a) it is the role of research to accurately and consistently identify fraudulent conduct which may lead to financial product failure, and
>
> b) that research houses should be able to accurately and consistently predict extraordinary market events which may cause market and in turn financial product failure.
>
> ASIC could provide specific and granular guidance that before recommending a financial product it is the ultimate responsibility of the financial adviser, not the research house, to understand the following:
>
> <u>The nature of the financial product</u>
>
> How complex is the financial product? What assets or other investments does the manager of the financial product invest into? What drives the performance of those investments? What are the key risks of the financial product which pertain to the probability of: a) loss of capital, b) loss of income, and c) loss of access to the investment (liquidity)? What are the objectives of the financial product? What is the likely performance of the financial product under common market scenarios? How tax efficient is the financial product at various marginal tax rates? Where the financial product's objective is stated as a targeted return, what is the likely split of return between capital growth and income? How, at all, does the financial product take into account environmental, social, or governance factors? What other features and benefits accompany the investment (eg insurance within a superannuation fund, platform implementation, administration and reporting features and benefits where the fund is accessed via a platform). What are the costs of investing into the financial product and accessing any additional features and benefits?
>
> <u>The investor types or investor scenarios best suited to the financial product</u>
>
> Based on the nature of the financial product and the financial adviser's knowledge of individual client needs, goals, objectives, tolerances, preferences and financial literacy, which clients are suitable for the financial product?

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65 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

> The appropriate use of the financial product
>
> For those clients deemed suitable, how does the financial product fit within an overall portfolio? What should be the maximum portfolio exposure limits (%) to the financial product? How is the financial product likely to interact with other investments within the portfolio (correlations)? What is the minimum time frame for investing into the financial product? What is the appropriate time frame to review the performance and efficacy of the financial product?[66]

3.79 Lonsec's criticisms do not apply to all financial advisory firms. As noted earlier, Dixon Advisory told the committee that a professional advisor must analyse a range of information from a variety of sources and that external research was only one input into informed investment advice.[67]

Committee view

3.80 This chapter has focussed on the role of research houses in the Australian financial system and in particular, their links to the upstream market (fund managers and product designers) and the downstream market (financial advisers and planners). It has noted that while ASIC has identified some measures to improve the quality of investment research in Regulatory Guide 79, there remain some fundamental systemic questions about the role of research houses, the utility of their products and the way they are remunerated.

3.81 The committee received some evidence that financial planners and financial advisers have not used research house reports to the extent that research houses would want. This may partly reflect the fact that financial planning firms have increasingly conducted their own in-house research; but it may also suggest that the type of general product research that research houses provide is simply not valued by financial advisers.

3.82 The committee believes that research houses' 'downstream' interactions with financial planners are particularly important. This is the 'user pays' business model. The utility of research houses, the quality of their research and the extent to which they should be held accountable for their output must all be linked to the end-users of their products—the clients of financial advisers and financial planners.

3.83 ASIC has told the committee that in using research house services, the financial adviser or planner will need to consider the business model of the research house, potential conflicts of interest because of the associations of the research house, how the research house selects products for rating, the methodology the research house employs and its spread of ratings. Even with this due diligence, it will be interesting to see whether the FOFA changes—with the best interest duty enshrined—

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66 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

67 Dixon Advisory, answer to question on notice, 28 June 2013 (received 12 July 2013).

will change financial advisers' and planners' uptake of research house products. It may be that financial planners need to do more of their own research.

3.84 In this context, the upstream linkages between research houses and fund managers are of concern. This is the 'issuer pays' business model. The committee believes that research houses should carefully manage their pecuniary arrangements with fund managers, whether direct or indirect. To the extent that these arrangements exist, they should be disclosed to ASIC and to financial advisers that use the research. The committee also supports ASIC's position that robust controls should be in place to ensure fee and contractual arrangements, relationship management and/or ancillary business units are kept separate from the ratings process and outcome.[68]

68 Australian Securities and Investments Commission, answer to question on notice, 27 June 2013 (received 23 July 2013), p. 4.

Chapter 4

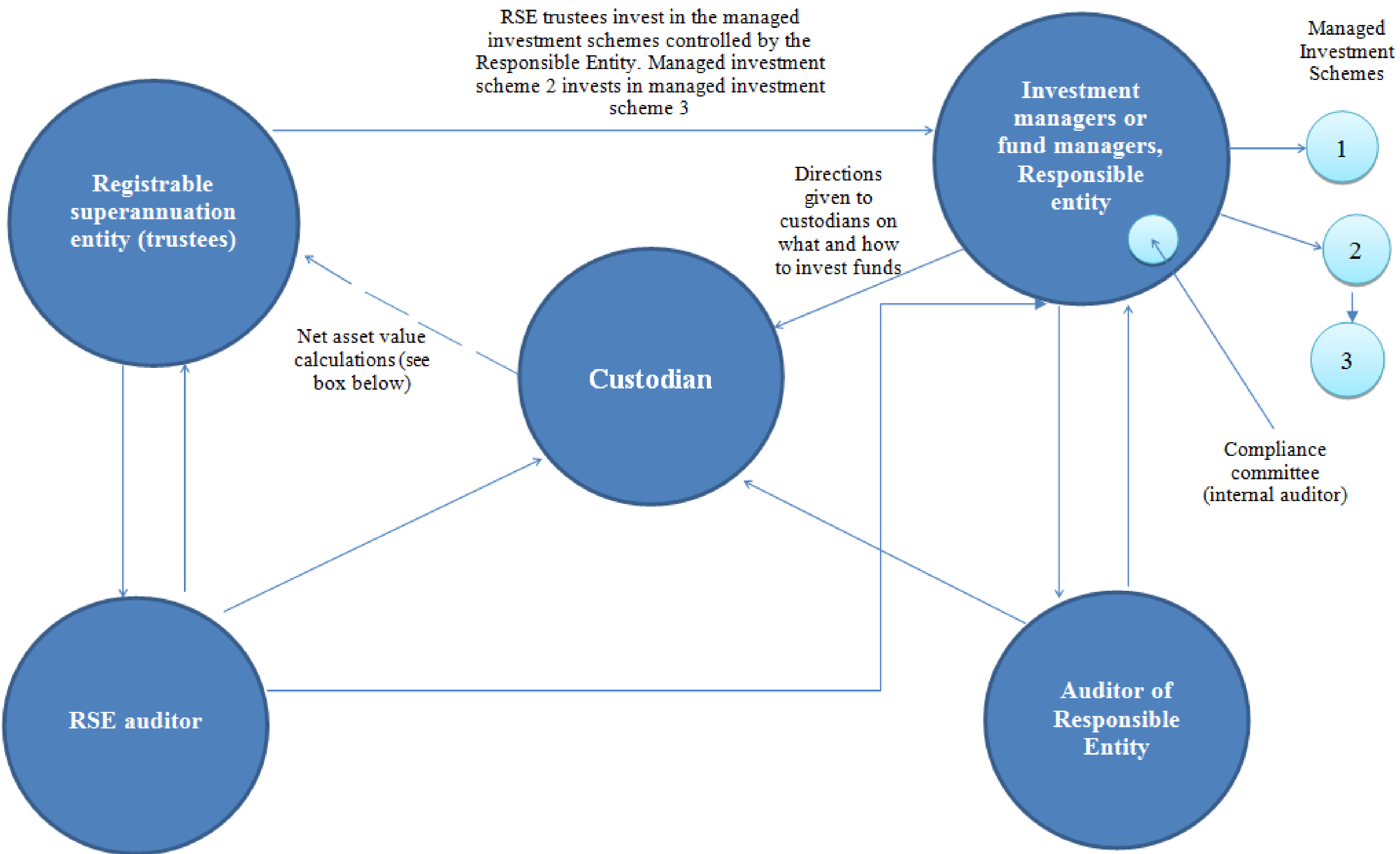
Interaction between custodians, responsible entities, trustees and auditors

4.1 This chapter presents the evidence from the second part of the gatekeepers' roundtable. It deals with the interactions shown in diagram 4.1 (next page) between custodians, responsible entities (REs), trustees, and the auditors of a registrable superannuation entity (RSE) trustee and an RE. Key issues such as the responsibility for asset valuation, portfolio disclosure and asset verification are also dealt with.

4.2 As was the case in chapter 3, when considering the evidence presented in this chapter, it is important to bear in mind the different business models that the various gatekeepers operate and the potential impact that those differences can have on the interactions between gatekeepers. As discussed in chapter 2, the different business models that have relevance in this chapter include:

- the different RE structures including internal REs and external REs;
- the combination of trustee functions whereby a company may offer custody, trustee and RE services;
- dual regulation where an RE is also licenced to provide RSE services; and
- the fact that an auditor may be the only truly independent gatekeeper in a situation where a large financial services corporation provides research, custody, trustee, RE, fund manager, financial planner and financial adviser functions.

Diagram 4.1



Role of the custodian

4.3 The committee's inquiry into the collapse of Trio Capital Limited (Trio) identified two misconceptions over the role of custodians. Firstly, even though custodians hold legal title to their client's assets, they do not exercise discretion over how the assets are managed or invested. Custodians only act on the proper authority of their direct client or authorised agent. In effect, they are a 'bare trustee'. Secondly, although custodians undertake regular valuations of client assets and report to the client on all custodially-held assets as required under the custody agreement, the custodian is not required to confirm the existence of the underlying assets.[1]

4.4 However, the Australian Custodial Services Association (ACSA) indicated that if a custodian suspected mismanagement within a managed investment scheme (MIS), they would notify the Australian Transaction Reports and Analysis Centre, the Australian Securities and Investments Commission (ASIC), or the Australian Prudential Regulation Authority (APRA) in the case of superannuation funds. Both Mr Paul Khoury, Deputy Chairman of ACSA, and Mr Pierre Jond, Chairman of ACSA, stated that these notifications were rare, and much less frequent than once a year.[2]

4.5 Given the limited role of a custodian, the committee sought clarification over which gatekeepers were responsible for valuing assets, verifying assets, and exercising discretion over the investment of assets. These responsibilities are discussed in the following sections.

Asset valuation

4.6 The Trio inquiry revealed the difficulty with establishing an accurate and robust valuation of assets, especially when those assets are held in overseas hedge funds. Indeed, despite the assertions of ASIC and APRA to the contrary, the committee was not convinced that the principal underlying asset of one of the fraudulent funds, the ARP Growth Fund, ever existed and had value.[3]

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1 Australian Custodial Services Association, *Submission 43*, p. 3 Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012; see also ANZ, *Submission 70*, p. 3, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

2 Mr Paul Khoury, Deputy Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, p. 14; Mr Pierre Jond, Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, p. 14.

3 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. xxi.

4.7 The valuation of assets is undertaken by the custodian in accordance with the information it receives from the trustee or RE and its investment managers, and/or agreed independent price sources.[4]

4.8 The process undertaken to value assets depends on the nature of the assets and the availability of independent price sources. In the case of listed securities, a custodian would normally source both primary and secondary prices from 'reputable pricing and information vendors in the securities industry'.[5] Typical sources for listed securities would be Bloomberg and Reuters.

4.9 Mr Jond noted that if the listed securities were invested overseas, a custodian would appoint a local banker in the overseas market to act as subcustodian, and would conduct regular due diligence on the overseas subcustodian.[6]

4.10 ACSA also explained the principles underpinning off-shore asset valuation:

> There is no consistent single practice across ACSA members for the location of staff who perform net asset valuation calculations. That said, a common practice, especially with the global banks, is to have some of the pre-work and first order calculations performed in offshore locations. This can include trade and corporate action processing, sourcing of asset prices and initial validation checks. Where any use of offshore locations is conducted, the following principles are adhered to:
>
> 1) The staff performing the work are employed by the relevant organization. That is the work is not 'outsourced' to a third party. They are staff of that organization and held to the same code of conduct and other expectations as if they were local staff.
>
> 2) Similar operational controls are performed as would be performed if the work was conducted locally.
>
> 3) The client location (in this case Australia) retains full accountability for the end product and often (but depending on each ACSA member's operational layout, possibly not in every situation) staff in Australia perform the final validation of the net asset valuation and release to the clients. This also means that the Australian staff would be responsible to explain any questions arising from the net asset valuation for the Australian clients.
>
> 4) The offshore locations are subject to Australian audit controls and oversight.

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4 Australian Custodial Services Association, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013.

5 Australian Custodial Services Association, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [2].

6 Mr Pierre Jond, Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, p. 12.

> 5) Onshore clients are able to visit and conduct due diligence of operations run outside of Australia.
>
> It is worth noting that, where it is available, the use of offshore locations achieves a global best practice so that Australian investors get the benefit of scale, knowledge, operating controls and systems development that is representative of the same core business approach as for the largest global funds.[7]

4.11 By contrast, in the case of unlisted securities or illiquid assets, or where pricing and information vendors are not available, the custodian would take pricing instructions from the client (the investment manager or RE) 'on an "as is" basis, with no additional checks other than certain tolerance checks'.[8]

4.12 BT Financial Group emphasised that responsibility for determining valuation methodologies and mechanisms lies, depending on the circumstance, with the RE or trustee:

> In terms of trustees' expectations of custodians in the valuation of assets (especially overseas assets and non-exchange traded assets), the relevant regulation (the SIS Act and APRA's Prudential Standards) makes clear that the responsibility for determining appropriate valuation methodologies for ALL assets of the superannuation fund is that of the trustee.
>
> The Corporations Act also specifies that a responsible entity is required to ensure that the property of the managed investment scheme is valued at regular intervals appropriate to the nature of the property – which includes determining the methodology for valuation.
>
> With respect to responsibility for obtaining robust and independent valuations of overseas assets and underlying asset values, it is our view that trustees and REs are responsible for ensuring that such valuations are obtained. The mechanism for obtaining the valuations will be part of the methodology determined by the trustee/RE.[9]

4.13 One Investment Group agreed with the division of responsibilities in securing and valuing the underlying assets of a scheme:

> It is our view that the role of a Custodian is to primarily hold assets on behalf of a Responsible Entity and to act on the proper instructions of a Responsible Entity in relation to those assets. Whilst a Custodian may be

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7 Australian Custodial Services Association, answer to question on notice, 28 June 2013 (received 5 July 2013).

8 Australian Custodial Services Association, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [3]; see also Mr Paul Khoury, Deputy Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, p. 13.

9 BT Financial Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. 2.

> expected to question suspicious transactions in relation to the assets in a scheme, their role is limited to notifying the Responsible Entity and/or ASIC.
>
> We believe that the expectation of the role of the Custodian in valuing assets is unjustified and note that the obligation to ensure the accuracy of the asset values rests with the Responsible Entity.[10]

4.14 The Trio inquiry had found that like the auditors and custodians, the research houses had relied on the information provided by Trio without verifying the accuracy of the information. Mr Epstein stated that he did not expect a research house to verify the existence of assets, and reiterated that it was the role of the RE to scrutinise the fund operations.[11]

4.15 Ms Karen Volpato, Senior Policy Adviser at the Australian Institute for Superannuation Trustees (AIST), concurred with the other roundtable participants that when an agreed price source is not available to independently price assets, the responsibility for obtaining a price falls on the trustee.[12]

4.16 The AIST noted that for unlisted assets such as direct property and infrastructure:

> There is a formal process for the appointment and review of valuers by Investment Committees and Boards. … In addition to the formal processes of appointing valuers, a fund may also appoint a suitably qualified expert to undertake a due diligence process in terms of valuation practices. Directly held assets are valued by qualified experts.[13]

Asset disclosure

4.17 In his evidence to the Trio inquiry, Mr Greg Medcraft, Chairman of ASIC, noted that the basic premise of an efficient market is the availability of information. He argued that the lack of disclosure to investors around scheme assets 'is a key weakness' in the system.[14]

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10 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [3].

11 Mr Justin Epstein, Executive Director, One Investment Group, *Proof Committee Hansard*, 21 June 2013, pp 9–10.

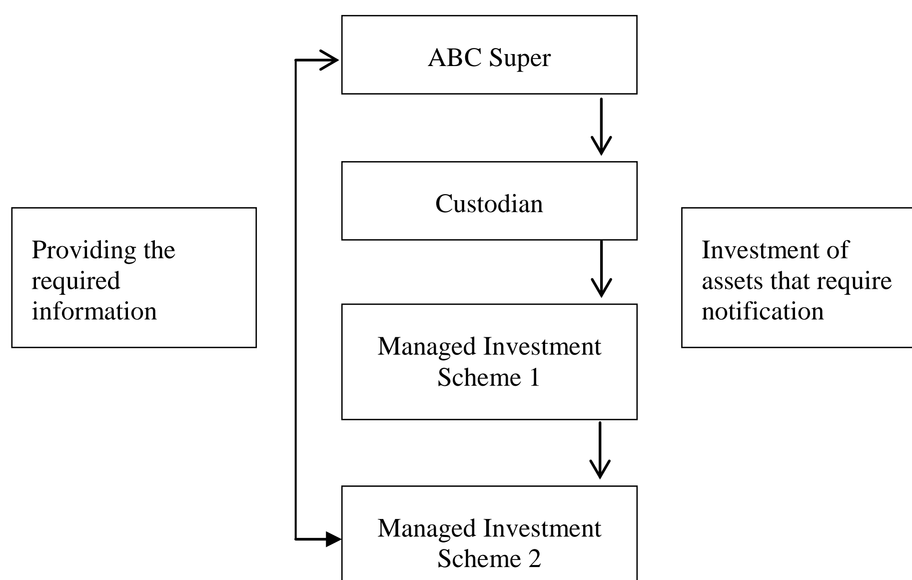
12 Ms Karen Volpato, Senior Policy Adviser, Australian Institute of Superannuation Trustees, *Proof Committee Hansard*, 21 June 2013, p. 24.

13 Australian Institute of Superannuation Trustees, answer to question on notice, 28 June 2013 (received 18 July 2013).

14 Mr Greg Medcraft, Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into the collapse of Trio Capital, *Committee Hansard* , 6 September 2011, p. 6.

4.18 From 1 July 2013, MySuper replaces existing default superannuation products.[15] The new MySuper regime requires the disclosure of portfolio holdings through quarterly reports. The steps are set out in the following diagram taken from the Explanatory Memorandum to the *Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012*.[16]

Diagram 4.2



4.19 In diagram 4.2, ABC Super is an RSE licensee that invests assets through a custodian into MIS 1. MIS 1 is a fund of funds that makes investments into other funds such as MIS 2. There are a series of notifications that must occur between ABC Super, the custodian, MIS 1 and MIS 2 (indicated by the arrows on the right hand side of the diagram). However, MIS 2 also has disclosure requirements:

> Managed Investment Scheme 2 will also have an obligation to provide information directly to ABC Super that is sufficient to identify its financial product, the financial products it acquires with the assets and other property that it acquires with the assets as well as the value of ABC Super's investment in each of these things.[17]

4.20 The committee understands that the requirement on RSEs to report to APRA commences 90 days after 1 July 2013. The requirement to report to ASIC will

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15 The Treasury, Australian Government, 'MySuper', Stronger Super, http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/information_pack/mysuper.htm (accessed 8 July 2013).

16 *Explanatory Memorandum*, Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012, p. 50, diagram 3.3.

17 *Explanatory Memorandum*, Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012, p. 49.

commence 90 days after 1 July 2014. ASIC has advised the committee that it is currently providing feedback and assistance to Treasury on the drafting of regulations in relation to portfolio holdings disclosure.[18] Previously, the proposed commencement of reporting to ASIC was 90 days after 31 December 2013.

4.21 Mr Khoury remarked that portfolio disclosure through quarterly reports will impose significant additional work on custodians to supply the underlying data. He acknowledged that custodians, REs, RSEs, ASIC and APRA were all busy preparing for the new regime.[19]

4.22 ACSA also questioned the practicality of enforcing an Australian requirement for asset disclosure on funds domiciled overseas.[20] Mr Khoury said that there were practical difficulties in trying to source data from complex overseas structures each comprising multiple subholdings.[21]

4.23 Mr Epstein went further and said that the requirement for an overseas scheme to report back to an RSE licensee was unrealistic because overseas hedge funds were not going to comply with disclosure requirements at the asset level.[22]

4.24 Recognising that Australian law does not cover overseas jurisdictions, the AIST said that Australian super funds use a 'best endeavours' approach to underlying assets.[23]

4.25 The committee is concerned that another 'expectation gap' could be created between what is expected of custodians and what they are actually able to deliver. Mr Khoury replied that in working closely with industry and the regulators, ACSA was being clear about what the limitations were in terms of reporting on underlying assets.[24]

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18 Australian Securities and Investments Commission, answer to question on notice, 27 June 2013 (received 23 July 2013), p. 2.

19 Mr Paul Khoury, Deputy Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, pp 21–22.

20 Mr Pierre Jond, Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, p. 21.

21 Mr Paul Khoury, Deputy Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, p. 22.

22 Mr Justin Epstein, Executive Director, One Investment Group, *Proof Committee Hansard*, 21 June 2013, p. 21.

23 Australian Institute of Superannuation Trustees, answer to question on notice, 28 June 2013 (received 18 July 2013).

24 Mr Paul Khoury, Deputy Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, p. 23.

4.26 In relation to the MySuper reforms on portfolio holdings, Mr Graeme McKenzie, Partner and Global Head of Pensions at Ernst & Young, expressed concern about the usefulness of collecting such large quantities of data. He also pointed to the potential for another expectation gap to arise and said that with so much data being fed back to APRA, there could be an (unrealistic) expectation that APRA would be able to analyse it all and become aware of a problem before it manifests:

> From an external audit perspective, the new requirements are quite demanding. The data points are increasing tenfold, and in some entities there are up to 5,000 data points that we need to actually verify. So it is quite a challenge. The whole industry has tried very hard to get on board and put things in place. I think APRA has been fairly understanding and they have pushed back by a year some aspects of the reporting, but the reporting is coming; it is not as though it is going away. In some ways, I have maybe a perverse view on the expectation gap, because I have a slight concern that APRA is going to have so much data, and it will be a question of what they do with that data. In this industry something will go wrong. It is just inevitable that a fund, perhaps, will have some issues. I must say that I have several concerns from an APRA perspective, because there might well be an expectation of: 'Hang on, APRA. You've actually collected this data. What have you done with it? What have you analysed?' Right down in the detail there is an issue with a particular subfund managed scheme or whatever else. I am not sure that APRA has necessarily turned their mind to this—and I am not saying they have not. But I must say that, with so much data being collected, it is difficult to see, from my perspective, what meaningful information will come back the other way in relation to the MySuper product.[25]

4.27 Mr Everingham of Lonsec stressed that having the right data was just as important as the volume of data. He emphasised that the key factor contributing to risk and return in any portfolio was actually the asset allocation rather than any one particular investment. He argued that the key disclosure related to whether the asset allocation in the portfolio reflected the original intentions of the investor:

> I want to make a point about what we would consider useful, because clearly you have to strike a balance between the volume of the information and the usefulness of it. When it comes to disclosing what is in portfolios, the contribution to the risk of the portfolios and the contribution to the return of the portfolios for investors is by far and away dictated by the asset allocation in the portfolio as opposed to any one individual investment. I think the more important disclosure is to ensure that an investor's asset allocation is staying within the parameters that were intended when the investor went into the portfolio, rather than more and more micro details

25 Mr Graeme McKenzie, Partner and Global Head of Pensions, Ernst & Young, *Proof Committee Hansard*, 21 June 2013, p. 23.

> down to which individual stock they are holding, because then what is to be done with that information?[26]

4.28 Mr Thomas drew a distinction between straightforward disclosure in vanilla markets (such as equities and bonds) and the vastly more complicated world of derivatives. He agreed with Mr Epstein's point that it was very difficult to get to the end point of the investment chain because hedge funds make extensive use of derivatives that can significantly impact on risk return ratios. Because derivatives are so complex, Mr Thomas said that the extra disclosure would be unlikely to facilitate an increased understanding of the risk dynamics of a particular underlying asset. Compounding the scale of the problem is the huge size of the derivative market which dwarfs the size of the global economy:

> In relation to disclosure, in the vanilla markets, yes, you have a share portfolio and you can see that you have got 10 per cent with BHP and NAB et cetera. I think Mr Epstein was touching on a very valid point, that sometimes disclosures do not really get to the end point because, in the world of hedge funds, derivatives can make a significant impact to the risk return dynamics that Mr Everingham is talking about and it is not transparent, even in the disclosure, as to what that dynamic or the skews of the return or the risk may be—notwithstanding deceptive conduct, because that is quite a separate issue. The derivative world is a huge world. It is much bigger than the GDP of the global economy; I think it is tenfold in terms of assets. It exists and it is a big part of investing. In most cases it is risk management, but in some cases in the hedge fund world it can skew the underlying piece. The provision of information is overwhelming, let alone being able to understand what derivatives are. I do not think it would add too much to the piece.[27]

4.29 Mr Brennan said that disclosure in jurisdictions such as the United States and the United Kingdom was more detailed than in Australia:

> I was involved in RAN, a mutual fund company in the United States for 3 years. We had several funds. All of the holdings of each of those funds in that family were disclosed—the name, the number of holdings, the dollar value of that exposure—for each of those assets every 6 months. Those statements in turn were audited by our external auditor to ensure they were absolutely correct. They were then entered into our public disclosure document, in that case, our prospectus. It made a lot of sense for us.[28]

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26 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 23.

27 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 23.

28 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 22.

4.30 Having acknowledged that greater disclosure was coming to Australia, Mr Brennan said that the essential factor would be to allow the RE to determine the appropriate level of disclosure because this could help ensure that disclosure to the investor was valuable:

> I think it always comes to the appropriate level of disclosure. I think you need to disclose certainly the top 10 or 20 holdings or a substantial part of the portfolio so that the investor can see it is an Australian equity fund: 'Lo and behold! It is invested in Woolies and BHP and RTZ. They are Australian names that I recognise and therefore am pretty certain it is an Australian equities fund.' So I think that level of disclosure makes a lot of sense. I think, though, when you get into very complex structures, which sophisticated investors wish to invest in, where you may have a number of funds below an overarching fund and then going down within those and commingling up the BHP holdings of all of them, you may in fact do nothing more than actually mislead. So I think, and I hope, that the disclosure will allow the RE to disclose in a way that is appropriate and is revealing to the investor as opposed to misleading to the investor, because this is a complex area and can easily mislead.[29]

Committee view on portfolio disclosure

4.31 The committee notes that two elements of the new *MySuper* requirements require resolution:

- firstly, the practicality of getting the requisite information from overseas entities; and
- secondly, the relative usefulness of the new information.

4.32 ASIC has stated that it cannot insist on the offshore fund reporting to the trustee as to where the money has been placed. However, ASIC expects that the trustee would report the initial offshore investment to the extent that it is known to the trustee.[30] The committee believes that if there does prove to be difficulty in gaining information on portfolio holdings from overseas entities, ASIC should investigate to determine whether the problem is systemic or circumstantial.

4.33 The committee also notes that the government is interested in extending portfolio holdings requirements to managed investment schemes. ASIC has noted to the committee that it 'has consistently expressed its full support for this position'. It

29 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 22.

30 Australian Securities and Investments Commission, answer to question on notice, 27 June 2013 (received 23 July 2013), p. 3.

has told the committee that the value of portfolio holdings disclosure applies equally to superannuation funds and managed investment schemes.[31]

The role of auditors

4.34 Auditors perform a series of critical roles within the financial services system. There are internal auditors (internal to an entity such as the members of an entity's audit committee) and independent external auditors. The roundtable was concerned principally with the role of independent external auditors, including their relationships with audit committees. External auditors conduct audits of various entities including custodians, RSEs and REs. External auditors audit the financial statements of an entity and also carry out compliance plan audits where they check that an RE has complied with an MIS's compliance plan and whether the plan continues to meet the requirements of Part 5C.4 of the Corporations Act.

Asset verification

4.35 One of the key expectation gaps identified in the Trio report was the frustration expressed by regulators and investors over the inability of financial and compliance plan auditors to verify information. In terms of diagram 4.1, the committee was keen to determine who was responsible for verifying the existence of underlying assets and how this would be achieved in practice, particularly if those assets were held in an overseas hedge fund. The committee recognised that the process of verifying assets becomes even more problematic when, as in the case of Trio, one or more of the directors of the RE is complicit in fraudulent activity.

4.36 Mr Amir Ghandar, Policy Adviser for Audit and Assurance at CPA Australia, said that the external auditor of the financial statements was responsible for obtaining reasonable assurance 'as to the existence of the assets on the balance sheet' at the time of the annual audit.[32] CPA Australia confirmed that:

> The same standards of obtaining reasonable assurance apply to all assets on the financial statements, regardless of whether those assets are held in Australia or overseas.[33]

4.37 However, Mr Ghandar recognised that the RE had an ongoing hands-on role in ensuring the security of scheme assets:

> the responsible entities in terms of the assets within the fund have a really crucial role and perhaps more of a day-to-day and during-the-year role and maybe a more granular role than when you are looking at the case of a large

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31 Australian Securities and Investments Commission, answer to question on notice, 27 June 2013 (received 23 July 2013), p. 3.

32 Mr Amir Ghandar, Policy Adviser, Audit and Assurance, CPA Australia, *Proof Committee Hansard*, 21 June 2013, p. 11.

33 CPA Australia, answer to question on notice, 28 June 2013 (received 12 July 2013).

> set of financial statements. But, in saying that, I think in a complex system which involves quite a number of different players, what is really important with more accessibility to everyday Australians is that the information that gets to those Australians is in a format that they can understand, that is clear and that is reliable—and that is a big part of what auditors do in terms of the annual financial statement audit.[34]

4.38 Mr McKenzie confirmed the central role played by the external auditor in confirming the existence and robust valuation of underlying assets,[35] but he also drew attention to the significant difficulties in detecting fraud:

> To be frank, from an external audit perspective, it is very challenging when there is fraud. We often send confirmations out to confirm the existence and valuation of assets. You receive a confirmation back in good faith. Certainly the antennae might be up if the fund is perhaps externally based overseas, so you might well dig a little deeper, but if you are receiving information back that appears bona fide it can be, I must say, quite a challenge.[36]

4.39 While recognising the vital role that financial and compliance plan auditors play in providing reasonable assurance to investors with regard to the position and performance of a scheme, One Investment Group argued that an expectation from investors that an auditor will provide absolute assurance that a scheme is free from error or fraud is 'unrealistic'.[37]

4.40 Furthermore, One Investment Group pointed out that the directors of a RE play the central role in ensuring the accuracy of financial statements, the proper operation of a scheme, and the protection and security of a scheme's investments.[38]

4.41 In effect, the RE is responsible for verifying the existence of scheme assets on an ongoing basis, whereas the auditor is responsible for obtaining reasonable assurance as to the existence of the assets at the time of the annual audit.

4.42 Both One Investment Group and BT Financial Group pointed out that it is also the role of the RE to appoint an auditor of sufficient capacity and competency to undertake the required audits.[39]

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34 Mr Amir Ghandar, Policy Adviser, Audit and Assurance, CPA Australia, *Proof Committee Hansard*, 21 June 2013, p. 11.

35 See also Ernst & Young, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013.

36 Mr Graeme McKenzie, Partner and Global Head of Pensions, Ernst & Young, *Proof Committee Hansard*, 21 June 2013, p. 12.

37 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, pp. [2–3].

38 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [3].

4.43 Mr McKenzie of Ernst & Young set out the process that an external auditor would go through to gain assurance regarding the assets of an MIS managed by an RE:

> We may have some interaction with the auditor of the responsible entity of this investment management fund if the investment is a controlled investment of the entity that we are auditing-so a very significant investment. But if it is a 'normal' investment, we would more typically go straight to the investment manager because we have no contractual relationship-and, indeed, typically it would certainly be a different firm or a different partner who would be responsible for that other audit of the responsible entity. And looking at many of the funds that we would audit, there would be multiple funds that ultimately a superannuation entity would enter into and so this diagram [diagram 4.1] on the right-hand side could be replicated 20 different times.[40]

4.44 Mr McKenzie explained the interaction between the auditor of the custodian and the auditor of the investment manager that will be signing off on the financial statements. He said that each custodian would have one auditor that went in to test the internal controls, and provide assurance over the existence and valuation of those assets that they are able to verify. In the case of unlisted securities, the custodian auditor would typically flag any particular securities that have not been tested. When the receiving audit firms gets the opinions, it is then incumbent on that audit firm to approach the fund manager and get confirmation on asset existence and value for the unlisted securities that were not tested by the custodian auditor. Mr McKenzie said that this mechanism for reporting between auditors is transparent, efficient, effective and has been adopted globally:

> There is an audit guidance in relation to dealing with both investment managers and custodians, GS 007, which sets out fairly clearly the responsibilities and the rights of both the user auditor—the auditor who is ultimately signing off the set of financial statements—and the auditor of, in this case, the custodian. There is quite a standard mechanism for sign-off of internal controls at the custodian, which has been in place for many years, where the custodian's auditor will go in and test the overall control environment at the custodian. That is an efficient and very effective mechanism. I cannot speak on behalf of the custodians, but as opposed to having every audit firm in Australia—be it State Street or BNP et cetera—going into it, you have one organisation very familiar with that organisation doing the control report.
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> That control report is a very transparent report. It clearly states that there are stated control objectives that have to be covered off in relation to a

39 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [3]; BT Financial Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. 3.

40 Mr Graeme McKenzie, Partner and Global Head of Pensions, Ernst & Young, *Proof Committee Hansard*, 21 June 2013, p. 13.

custodian. They are clearly stated in the GS 007, which was a development made over the last four or five years by the auditing standards board which states that you must cover off these control assertions. It is very transparent reporting on the testing that has been performed and on the results of that testing. That mechanism has been in place for many years. It has been adopted both locally and internationally, and I think that it is an efficient and effective way of gaining assurance over the controls that are operating.

On the question of asset existence and evaluation, under this GS 007 audit guidance standard there are mechanisms where the auditor of the custodian can provide that assurance to the ultimate auditor. The ultimate auditor, and indeed the trustee or the responsible entity, does not necessarily have to have that assurance. It is not as though it is forced upon them. But, again, it is seen as an efficient and effective way to gain assurance. So as opposed to each audit firm going in and testing valuations of, let's say, BHP shares for this managed scheme and that managed scheme, the one audit firm will test BHP in this case across all of the schemes and ultimately report that to each of the individual auditors. So it is, as I say, an effective mechanism; it is efficient. The reporting back is quite transparent.

… the existence of valuation of standard style investments—equities and fixed interest et cetera—is fairly straightforward, to be honest, and quite mechanical in how that is done. Where an issue arises, as we have also heard, is where it is an unlisted security. Typically, the auditor of the custodian will not form a view on those types of assets and will specifically call out in their audit opinion that they have not conducted testing on these assets—they typically will have a reference schedule where they are all listed.

Arguably, there has been a potential failing where receiving audit firms have got the opinions. They say, 'Great, we've got an opinion from Ernst & Young, PricewaterhouseCoopers or whoever else. Okay, we're done,' without detailed reading of what is included and excluded. I do not think this is a widespread issue, but I can see that it could happen. I know that some of my graduates get the files and say, 'We're done,' and I say, 'No, we are not done at all.' In these particular assets, where the other audit firm has not provided assurance at all, we must dig deeper, issue confirmations and get information from the fund managers ourselves on the existence and the valuation of the assets. You are right in saying that there is a mechanism in place. It is a well-documented and approved mechanism, if you like, through the auditing standards. I think it is efficient and effective, but, on the use of the material, you really need to understand what you are getting when you get the material; you must understand those reports in a lot of detail.[41]

41 Mr Graeme McKenzie, Partner and Global Head of Pensions, Ernst & Young, *Proof Committee Hansard*, 21 June 2013, pp 25–26; see also Ernst & Young, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, pp 3–4.

4.45 In an answer to a question on notice, ASIC told the committee that as part of its audit inspection program report for 2011–12, it found that auditors of compliance plans 'did not always obtain sufficient and appropriate audit evidence on which to base their conclusions'. This included:

- whether the compliance plan continued to meet the requirements of Pt 5C.4 of the Corporations Act;
- the adequacy of procedures for reporting and assessing breaches of the compliance plan;
- the assessment of whether the service organisation auditor’s report could be relied on in relation to outsourced functions, risk assessments performed by the auditors, and the relationship to work performed on areas of the compliance plan audit; and
- the testing of specific areas, such as subsequent events up to the date of issuing the compliance plan audit report, net tangible asset calculations (for the responsible entity), and cash flow projections.[42]

4.46 Mr McKenzie also pointed out that auditors of financial statements are registered with ASIC and submit annually information about the audits that they have conducted. However, he did not necessarily see a need for compliance plan auditors to be registered with ASIC, and said that Ernst & Young had a risk management policy that authorised only a small number of suitably qualified partners with the requisite levels of professional scepticism to sign compliance plan audits.[43]

Relationships between the auditor of the financial statements and the compliance plan auditor

4.47 Under section 601HG(2) of the Corporations Act, the auditor of an entity's compliance plan cannot be the auditor of that entity's financial statements, although the auditors may work for the same audit firm.[44] However, as Ernst & Young point out, 'there is no prohibition on the compliance plan auditor also performing the statutory audit of the fund's financial statements'.[45]

4.48 The committee sought clarification on why these auditing duties were separated, what impact, if any, it had on auditor performance, and which of the auditors would have responsibility for detecting fraud. Ernst & Young explained their

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42 Australian Securities and Investments Commission, answer to question on notice, 27 June 2013 (received 24 July 2013), pp [5–6]. See also Australian Securities and Investments Commission, *Audit Inspection Program Report 2011–12*, Report No. 317, December 2012, p. 16.

43 Mr Graeme McKenzie, Partner and Global Head of Pensions, Ernst & Young, *Proof Committee Hansard*, 21 June 2013, p. 26.

44 *Corporations Act*, s. 601HG(2).

45 Ernst & Young, answer to question on notice, 28 June 2013 (received 11 July 2013), p. 2.

understanding of the separation of compliance and financial statement auditing functions:

> We understand that the segmentation between compliance plan auditor and the auditor of the Responsible Entity (RE) (not the fund financials) is due to the philosophy that the compliance plan auditor should have the best interest of the investors in the fund front of mind, while the auditor of the RE should consider more the interests of the shareholders of that corporate entity. There appeared to be a belief that there may be a conflict of interest if auditing both the compliance plan and the RE.[46]

4.49 While the separation of auditing roles was 'not a major concern' for Ernst & Young, it stated that:

> The separation does not inhibit the performance of effective and robust compliance plan audits, but there is no doubt that having separate partners involved on what is effectively the one audit is less efficient.[47]

4.50 The committee also asked ASIC why the auditor of the entity's compliance plan cannot be the auditor of the entity's financial statements. ASIC responded:

> The independence and objectivity of the auditor is an important contributor to audit quality and market confidence in the independence assurance provided by the auditor. Having a separate person within a firm audit the compliance plan to the auditor of the financial report of the responsible entity can only enhance the independence and objectivity of the auditors. The risk and perception that the auditor may be less willing to raise and report concerns in the compliance plan audit to avoid any impact on the relationship with the responsible entity and fees from that entity is reduced.[48]

4.51 As noted earlier, the directors and managers of the RE are charged with the responsibility to establish appropriate risk management systems to reduce the risk of fraud with regard to a registered MIS. It was also noted that the auditor of the financial statements is responsible for obtaining reasonable assurance as to the existence of scheme assets.

4.52 In terms of the assets of an MIS, Ernst & Young noted that although the compliance plan auditor would seek assurance about scheme property, 'typically such assurance will be provided to the compliance plan auditor from the financial auditor'.[49]

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46 Ernst & Young, answer to question on notice, 28 June 2013 (received 11 July 2013), p. 2.

47 Ernst & Young, answer to question on notice, 28 June 2013 (received 11 July 2013).

48 Australian Securities and Investments Commission, answer to question on notice, 27 June 2013 (received 24 July 2013), p.[4].

49 Ernst & Young, answer to question on notice, 28 June 2013 (received 11 July 2013).

4.53 Given the separation of duties between a compliance auditor and financial statement auditor, Ernst & Young said that in general, a financial statement auditor would be 'better placed to identify instances of fraud' and that:

> it would be unlikely, but not inconceivable, for a compliance plan auditor to identify instances of fraud. We form that view based on the quite specific role that a compliance plan auditor executes, being the assessment of whether the Plan complies with the Law and the operation of that plan in practice, as opposed to the broader role of a financial auditor.[50]

4.54 Nevertheless, both CPA Australia and Ernst & Young stated that an external auditor (compliance auditor or financial statement auditor) would report fraud to senior management and the directors (generally via the Audit Committee) and to ASIC.[51]

4.55 ASIC confirmed to the committee that a compliance plan audit is not designed to identify fraud. It noted that the audit might identify a failure to apply controls which would may help reduce the risk of fraud occurring and in this way may attract attention to a fraud.[52]

Suggestions to improve audit quality

4.56 The committee acknowledges that the audit profession is pursuing global and domestic initiatives and working with ASIC to improve audit quality and to render audits more meaningful for investors.

4.57 Dixon Advisory recommended three steps to improve audit quality within the existing regulatory framework rather than trying to raise the threshold for reasonable assurance (which would be unlikely to pass a cost benefit analysis):

- Requiring that the audit of managed investment schemes is more robust as investors and the public confidence in the financial system rely on the audits being performed to a high standard. The cost of this will ultimately be borne by the investor but the audit opinion will be more meaningful.
- Putting more focus on using emphasis of matter paragraphs and highlighting these to the investor if there is uncertainty in the financial statements. This is particularly relevant if there has been uncertainty when testing the existence and/or valuation of assets.
- Increasing the standard of the half yearly audit review for managed investment schemes so that the chance of fraud being uncovered on a timely basis is

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50 Ernst & Young, answer to question on notice, 28 June 2013 (received 11 July 2013).

51 Ernst & Young, answer to question on notice, 28 June 2013 (received 11 July 2013); CPA Australia, answer to question on notice, 28 June 2013 (received 12 July 2013).

52 Australian Securities and Investments Commission, answer to question on notice, 27 June 2013 (received 24 July 2013), p. [6].

> increased. A full audit every six months would be more costly but the outcome of an audit is more useful to an investor than that of a review.[53]

4.58 CPA Australia welcomed specific suggestions that would make audits more meaningful for investors:

> CPA Australia recognises the importance of the audits conducted in respect of managed investment schemes for investors and the public, and the need for these to be performed to as high a standard as possible. We believe the standards applicable for managed investment scheme audits are comprehensive, robust and internationally equivalent and are committed to constant improvement in audit quality (see also CPA Australia's submission to the Committee dated 20 March 2013). We would welcome any specific suggestions as to how audits could be made to be more meaningful for investors.[54]

4.59 CPA Australia also supported the use of emphasis of matter paragraphs to highlight matters of importance and noted that the auditing profession is currently drafting new standards in this area:

> CPA Australia supports the use of emphasis of matter paragraphs to highlight matters that are fundamental to users' understanding of financial statements. A substantial project currently being undertaken by the audit profession is to expand the auditor's report to include narrative information on key matters of audit significance (see also response to question 9(b) of the questions on notice from the Committee). Based on early draft standards, we expect these enhanced requirements will include the auditor providing information regarding uncertainty in the financial statements such as accounting estimates with high estimation uncertainty. This model is expected to be encapsulated in a draft standard to be exposed in July 2013.[55]

4.60 Ernst & Young noted that emphasis of matter paragraphs are typically 'used to highlight uncertainty - about the future financial performance, or the outcome of a legal case, for example'.[56] However, it stressed that the overuse of such paragraphs may be counter-productive:

> While on first read of the above it may be concluded that arguably there should be more emphasis of matters in audit reports, ASA 706[57] does state

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53 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [4].

54 CPA Australia, correspondence to the committee, 12 July 2013.

55 CPA Australia, correspondence to the committee, 12 July 2013.

56 Ernst & Young, answer to question on notice, 10 July 2013 (received 16 July 2013), p. 3.

57 ASA 706 refers to Auditing Standard ASA 706—*Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. It was prepared by the Auditing and Assurance Standards Board (AUASB) on 27 June 2011.

> that a proliferation of emphasis of matter paragraphs is not desirable as it diminishes the effectiveness of an auditor's communication with stakeholders. From an audit profession perspective we believe that it is more desirable that companies/funds provide adequate disclosure in the financial statements so that the need for emphasis of matters is diminished.[58]

4.61 Ernst & Young said that an audit is significantly more rigorous than a review, and pointed out that their reviews contain a declaration stating that the review does not express an audit opinion. It estimated that a review would cost about one-third the amount of an audit.[59]

4.62 While acknowledging that performing an audit twice a year would increase the level of assurance, CPA Australia pointed out that it would need cost-benefit justification from an investor perspective:

> Requiring an audit every six months would increase the level of assurance obtained by the auditor in the half year engagement, and also increase the cost involved in comparison to a half year review. It is critical that any consideration of this suggestion is undertaken on the basis of the costs and benefits from the perspective of investors.[60]

4.63 Dixon Advisory maintained that a twice-yearly audit would be manageable because the additional costs would be spread across all unit holders in an MIS:

> The cost impact per unit holder of the implementation of a more robust audit program and an increased standard of half yearly audits is unlikely to be material for the average MIS. This is because the cost will be proportionately shared across all unit holders regardless of if they are an active or passive investor. We are confident that unit holders would be willing to pay this additional cost as it would provide active investors with more reliable information on how their investment is being managed and passive investors would view the additional cost as the price of 'peace of mind'.[61]

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58 Ernst & Young, answer to question on notice, 10 July 2013 (received 16 July 2013), p. 4.

59 Ernst & Young, answer to question on notice, 10 July 2013 (received 16 July 2013), p. 4.

60 CPA Australia, correspondence to the committee, 12 July 2013.

61 Dixon Advisory, correspondence to the committee, 18 July 2013.

Structure of the auditing industry and relationships with an audit committee

4.64 In the previous ASIC oversight report, the committee noted that the structure of the audit industry is of particular interest given that four large audit firms dominate the global and Australian audit market: PricewaterhouseCoopers, Deloitte, Ernst & Young and KPMG.[62]

4.65 The previous ASIC report also highlighted the provisional findings put forward by the Competition Commission in the UK that 'shareholders play very little role in appointing auditors compared to executive management', and that where the demands of executive management and shareholders differ, auditors compete to satisfy management rather than shareholder needs.[63]

4.66 The structure of the audit industry and the conflicting pressures that auditors face has raised concerns both internationally and within Australia about the extent of competition within the audit market and the potential impact on audit quality that arises when an audit firm has to balance commercial pressures (retaining client contracts) with adherence to audit quality (highlighting matters of concern in financial statements and/or compliance plans).

4.67 In responding to a question about whether they believed the findings of the UK Competition Commission were applicable to Australia, Ernst & Young said that this was not how the interaction between auditors, management, shareholders and directors worked in practice:

> While globally and potentially locally the perception may be that external auditors 'compete to satisfy management' the reality is quite different. Certainly to ensure an efficient and effective audit it is appropriate to have good, professional, working relationships with management, however we clearly see that our ultimate stakeholder to be the shareholder. From a practical perspective, that relationship is managed by Board Audit Committees.
>
> It should also be noted that shareholders, via the directors, do appoint external auditors, not management.[64]

4.68 An audit committee is a sub-committee of the main board that acts under delegated authority, furnishing a link between management, the board and the external auditor. It provides the interface for discussions with both internal and external

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62 Parliamentary Joint Committee on Corporations and Financial Services, *Statutory Oversight of the Australian Securities and Investments Commission,* No. 2, May 2013, p. 14.

63 Ms Laura Carstensen, Chair, UK Audit Investigation Group, cited in Competition Commission (UK), 'Audit market not serving shareholders', Media release, 22 February 2013, www.competition-commission.org.uk/media-centre/latest-news/2013/Feb/audit-market-not-serving-shareholders (accessed 27 March 2013).

64 Ernst & Young, answer to question on notice, 28 June 2013 (received 11 July 2013).

auditors and its role is to ensure the 'integrity and transparency of corporate reporting'.[65]

4.69 CPA Australia pointed out that they have 'publicly supported the UK Competition Commission's proposals to strengthen the role of audit committees and enhance shareholder engagement in auditor appointments'.[66] It stated that because directors and audit committees represent shareholders and investors and also function closely with the business, they are the group best positioned to oversight the performance of the auditor.[67]

4.70 Ernst & Young said that the membership of the audit committee 'will generally dictate how robust they are in their assessment of an external auditor's professional skepticism and work overall'. However, it did note that since the Centro failure, audit committees 'have become significantly more interested in the findings of the external auditor and engage/challenge with more vigour than historically'.[68]

4.71 Ernst & Young also explained its interaction with an audit committee, noting that not every RE has an audit committee:

> If an RE has an Audit Committee (and not all do) then we would have a range of interactions with them. At a minimum we would:
>
> - provide a summary of our audit plan/approach, provide engagement letters, inclusive of fees for approval;
> - provide status updates and then report back on the findings of the audit both in the context of the areas of focus outlined in our audit plan and any new issues;
> - cover a range of matters that we need to address to those charged with Governance, including independence, fraud, etc.
>
> Where an RE does not have an Audit Committee, then the interaction will vary depending on the overall corporate structure in which the RE operates in, whether there is a majority of independents (and therefore no need for a Compliance Committee), and the general preference/desires of the Board. At a minimum we would provide a copy of our engagement letter and then a letter to those charged with governance at the completion of the audit.[69]

4.72 In terms of the visibility of the contribution made by auditors, Ernst & Young said that:

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65 PricewaterhouseCoopers, Audit Committee guide introduction, p. 3, http://www.pwc.com.au/assurance/publications/audit-committee-guide/introduction.htm (accessed 18 July 2013).

66 CPA Australia, answer to question on notice, 28 June 2013 (received 12 July 2013).

67 CPA Australia, answer to question on notice, 28 June 2013 (received 12 July 2013), p. 15.

68 Ernst & Young, answer to question on notice, 28 June 2013 (received 11 July 2013), p. 7.

69 Ernst & Young, answer to question on notice, 28 June 2013 (received 11 July 2013), pp 6–7.

> Much of the auditors' best work is done behind the scenes, in discussions with client management about accounting requirements and key judgments and assumptions, to help produce information that provides a true and fair view and complies with accounting standards.[70]

Discussion on the role of trustees and the business and governance models of responsible entities

4.73 The following sections present the roundtable discussion on the role of superannuation trustees, the different business models and governance models used for REs, and the role of compliance committees.

The role of the trustee

4.74 As explained in chapter 2, a trustee is a person or company that holds or administers property or assets on behalf of a beneficiary. An APRA-regulated RSE is required to have a trustee. An RSE, whether an industry or retail superannuation fund, has a trustee board that is required to act in the best interest of scheme members. Board membership in an industry fund typically has both employer and employee representatives. By contrast, in a self-managed superannuation fund (SMSF), the members are the trustees.

4.75 The three main licensed trustee company roles are debenture issuers, RE and custodian. The role of the RE is similar to that of a trustee, but the RE has more statutory obligations.[71] As discussed in chapter 2, One Investment Group is licenced to act as a trustee for an unregistered MIS and as RE for registered MISs.

4.76 Dixon Advisory agreed that, where necessary, trustees need to engage independent experts to examine the assumptions and methodology used by custodians in asset valuations. However, they also noted that auditors are driving change in ascertaining the existence of underlying assets and their valuation:

> Our experience is that auditors are already driving improvement in this area by ensuring that a process exists to make sure the assets held by custodians exist and the correct valuation in used.[72]

4.77 Ms Karen Volpato, Senior Policy Adviser at the Australian Institute of Superannuation Trustees (AIST), indicated that since Trio and with the changes to the superannuation system including MySuper, there was a heightened awareness among

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70 Ernst & Young, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. 4; see also Ernst & Young, answer to question on notice, 28 June 2013 (received 11 July 2013).

71 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

72 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [4].

trustees of the need to be actively engaged in the valuation process and to review their risk management frameworks. She also noted that the new prudential standards are very detailed with regard to outsourcing arrangements that a trustee may have with a custodian, investment manager or fund administrator, and that when APRA conducts an operational review of a trustee, it is 'a long and extensive process'. As a consequence, governance issues and risk appetite are a high priority for trustees as they strive to achieve best practice.[73]

4.78 In response to a question about risk appetite, Ms Volpato gave the following description of how risk management might be consciously assessed within the trustee business:

> For example, a question that could be asked of the trustees within a fund is: what keeps you awake at night, as a trustee, given your personal liabilities and responsibilities to the members of this fund? That might help highlight those particular issues that are of an extreme-risk nature to the fund. Then the entire management team and the trustee board have to look at the various processes and procedures within both the fund and the material outsourced providers—be they custodians, investment managers or fund administrators—and at how they can better ensure a decrease in the likelihood of this risk occurring.[74]

4.79 Mr Codina added that just as the Future of Financial Advice reforms would raise standards across the financial planning and advisory sector, the new prudential standards directly address operational and governance issues and would 'raise the bar' across the trustee sector.[75]

4.80 Speaking as a representative of a large group that contains Authorised Deposit-taking Institutions that have been subject to prudential standards for many years, Mr Brennan agreed that risk management standards would be raised because the new 'superannuation prudential standards are very closely modelled on the APRA prudential standards for large banks'. He noted:

> Those are very high standards, matured over quite a long period of time, and as they are inculcated into the superannuation industry more widely in the coming years you will see quite an appreciable lift in risk management and, more generally, across the whole of the operation.[76]

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73 Ms Karen Volpato, Senior Policy Adviser, Australian Institute of Superannuation Trustees, *Proof Committee Hansard*, 21 June 2013, p. 24.

74 Ms Karen Volpato, Senior Policy Adviser, Australian Institute of Superannuation Trustees, *Proof Committee Hansard*, 21 June 2013, p. 25.

75 Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 24.

76 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 24.

4.81 The committee asked whether there were advantages in being able to act as both an RE and RSE. BT Financial Group pointed out that while it is a holding company and not a regulated entity, there are dual-regulated entities within its group. It noted that:

> The Stronger Super reforms that have amended the duties of RSE licensees and their directors are very closely modelled on those that apply to REs.
>
> By combining the roles of RE and RSE licensee in a single company and Board, the beneficiaries of the company's managed investment schemes and superannuation funds benefit from:
>
> - the specialist expertise of trustee directors appointed for their relevant knowledge and skills;
> - risk management and conflicts management systems directed to the roles and duties of trustees; and
> - specialist advisers including in-house counsel, who specialise in advising trustees.[77]

Business and governance models for a Responsible Entity

4.82 In the Trio collapse, the RE (Trio Capital) was at the centre of the fraud. It acted as RSE trustee and as RE with responsibility for various MISs. The vast majority of the MISs were legitimate, but one (or possibly two) of the MISs was used as a vehicle for fraudulent activity.

4.83 Given the critical gatekeeper role performed by the RE and its directors in the financial services system (discussed in the earlier section on asset verification), and given that it was the RE itself that was involved in the Trio fraud, the advantages of a business model that operated with either an internal or external RE were canvassed at the roundtable.

4.84 Mr Epstein argued that an external independent RE is a preferable and more prudent arrangement because it 'minimises conflicts of interest and reduces the likelihood of the RE acting in a detrimental manner to investors'. He noted that the risk of an internal RE acting in a manner detrimental to investors is not necessarily removed with the appointment of non-executive independent directors.[78]

4.85 Expertise, specialist resources, and economies of scale were also nominated as additional advantages in a scheme appointing an external RE:

> Further, an independent Responsible Entity that specialises in providing Responsible Entity services to a range of clients is likely to possess a higher degree of expertise and specialised resources to assist in the operation of a

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77 BT Financial Group, answer to question on notice, 28 June 2013 (received 12 July 2013), p. 5.

78 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, pp [1–2].

> scheme in addition to providing better and truly independent oversight. Given the economies of scale an independent responsible entity can enjoy, there is no reason an external responsible entity should burden a scheme with additional costs when compared to an internal responsible entity. Whilst we are not proposing that an independent responsible entity be mandatory, perhaps an "if not, why not" approach similar to the ASX Listing Rules relating to Corporate Governance Principles could be considered.[79]

4.86 The merits of an internal versus an external RE were also discussed with respect to the size of the fund manager and their internal capabilities. Mr Epstein questioned the ability of smaller fund managers to conduct the RE function internally, and suggested that in such cases, the reasons for keeping the RE function in-house should be disclosed:

> The argument I put forward in my paper is that the role of an independent responsible entity is absolutely critical. That is beneficial to my group in that we do look after a lot. I am not suggesting that groups such as BT, for example, outsource the responsible entity function. Without question, the responsible entity function within BT would be more than capable of performing that function, but ultimately it is the responsible entity that is responsible to the investors. So, whilst it might be appropriate for large responsible entities that look after large fund managers to perform that function, I propose that, in the event that you had a smaller manager or responsible entity looking after that function, there might be an expectation that that responsible entity or that fund would disclose why it did not see it as appropriate to appoint an external responsible entity. They have the expertise and they are independent of the manager.
>
> My background is that I come from an environment where I have worked for what I would say is a fairly large fund manager. It had an internal responsible entity and I would argue that it is questionable whether an internal responsible entity, regardless of whether it has independent directors, is appropriately qualified to determine whether the operations of the fund are run correctly. They do not have the expertise. They do not have the ability to spend the time to actually overlook it day to day.[80]

4.87 However, Mr Brennan pointed out that the choice of internal versus external RE depends on the internal RE capability of the fund manager:

> It comes down to fitness, properness, expertise and capability. We are a large organisation and our independent directors are extraordinarily able in this industry. They are, because we have selected them carefully. They keep the appropriate discipline on management. Management, in turn, is

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79 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [2].

80 Mr Justin Epstein, Executive Director, One Investment Group, *Proof Committee Hansard*, 21 June 2013, p. 10.

> extraordinarily capable because we make sure that they are when looking at underlying investments that are being put onto our platforms to our trustee and made available to underlying investors. As you come down the scale [in terms of size and resourcing capability], the level of fitness and properness may not be as strong.[81]

4.88 Dixon Advisory disagreed with the view put forward by One Investment Group that an external RE is preferable. Instead, Dixon Advisory firmly favoured the internal RE model with an independent compliance committee:

> In our view an internal RE with an independent compliance committee (ICC) represents the best model for investors. This is because the structured approach of an ICC with an ASIC approved compliance program drives a culture of compliance within the RE and ensures that there are unconflicted persons who can report breaches to ASIC.
>
> We believe that an ICC should be required even if the board of the RE is majority independent. It is a mistake to assume that simply because the board is independent they have the relevant skill or time to appropriately attend to compliance reviews.[82]

4.89 Dixon Advisory highlighted significant disadvantages in the external RE model, and drew attention to a conflict between the commercial interests of the RE and its duty to the members of the MIS:

> There are some strong disadvantages of the out-sourced RE model. These are:
>
> - The directors of an external RE are not involved in the day to day operations of a Managed Investment Scheme (MIS). This can mean that their access to information concerning the MIS for which they are appointed is limited, leading to a heightened risk of fraud and non compliance.
> - As an external RE is a standalone enterprise a conflict exists between the RE's responsibilities to the members of an MIS and the RE's commercial interests. This can lead to two issues:
>   - The RE may accept new, unqualified appointments, from parties they have no history or knowledge of.
>   - If the revenue stream that the RE receives from an MIS represents a significant portion of their total income, independence is compromised and the likelihood of reporting breaches or non-compliance is reduced.[83]

4.90 Based on the arguments above, Dixon Advisory said that 'ASIC should consider disallowing' external RE arrangements.

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81 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 10.

82 Dixon Advisory, correspondence to the committee, 18 July 2013.

83 Dixon Advisory, correspondence to the committee, 18 July 2013.

The role of compliance committees

4.91 The role of compliance committees and the nature of compliance plan audits were a major issue in the Trio inquiry. KPMG suggested that there was a need for greater oversight of managed investment schemes. KPMG argued that one option would be to mandate a majority of truly independent directors of the responsible entity which would remove the need for a compliance committee.[84] The second option would be to strengthen the role of the compliance committees and hold management accountable for acting on the recommendations of the compliance committee.[85]

4.92 Dixon Advisory recommended that a compliance committee should be compulsory for REs in all cases:

> Responsible entities should be required to have an independent compliance committee in all circumstances (compared to the current situation where they are only required in situations where the Responsible Entity's board is not made up of a majority of independent directors). This will lead to a situation where all responsible entities have people whose sole responsibility is to ensure compliance.[86]

4.93 Noting some specific concerns with the first option (independent directors) put forward by KPMG, CPA Australia suggested that the second option of strengthening the role of compliance committees might be a more practical approach.[87]

4.94 Ernst & Young said that it has seen both models in operation and that 'it is difficult to comment if one is better/stronger than the other'. While noting that appropriately qualified independent directors could 'bring a wealth of experience, insight and challenge to a business', Ernst & Young did, however, identify a potential pitfall in a compliance committee that was divorced from the business:

> What we would say however is that at times we have seen Compliance Committees operate quite separately from the business. While this is a positive from an independence of thinking perspective, it is also possible that there could be items that "fall between the cracks" without having a full business perspective.
>
> The model adopted by businesses will depend on how they operate their RE. If the RE board is very active in the management of the business it may not be appropriate/desirable to have independents dealing in such detail

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84 KPMG, *submission 69*, p. 15, paragraph 101, Inquiry into the collapse of Trio Capital Limited, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

85 KPMG, *submission 69*, p. 15, paragraph 101, Inquiry into the collapse of Trio Capital Limited, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

86 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [4].

87 CPA Australia, answer to question on notice, 28 June 2013 (received 12 July 2013).

(and incurring additional cost for the RE and ultimately the investors in the fund).[88]

4.95 Dixon Advisory was also of the view that the directors of an RE 'should have a minimum level of relevant education and experience in relation to the scheme they are managing'. They noted that at present, only the responsible manager has these requirements and yet the directors of the RE make most of the operational decisions for a MIS.[89]

4.96 Finally, given that a compliance plan auditor is only required to ascertain the compliance of an RE with its compliance plan, the committee was keen to establish who is actually responsible for ensuring that an RE adheres to the constitution of the RE's MIS. BT Financial Group confirmed that this was a responsibility for the RE's board of directors.[90]

Committee view

4.97 The committee believes that the relationship between REs and custodians is an important, but misunderstood, link in the operation of Australia's financial system. The committee recommended in its Trio Capital report that ASIC consider changing the name 'custodian' to a term that better reflects the current role of a custodian.[91] The committee notes ACSA's concerns about the confusion that a name-change would create, given the term 'custodian' is widely used internationally. However, it believes there is a need to better inform investors about what custodians actually do. To this end, the committee supports proposals to ensure that REs and other financial product issuers provide clear disclosure about the role of custodians in Product Disclosure Statements and retail marketing material.

4.98 The committee notes ASIC's consultations over the past 12 months on issues including the net tangible asset (NTA) requirement for custodians. It supports ASIC's decision to increase the NTA requirement to the greater of $10 million or 10 per cent of average revenue. The committee also welcomes the recent changes to enhance custodians' obligations in asset disclosure. While this will impose additional work on custodians to supply the underlying data, this is outweighed by the benefits to superannuation trustees from greater transparency in complex and diffuse investment structures.

88 Ernst & Young, answer to question on notice, 28 June 2013 (received 11 July 2013).

89 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [4].

90 BT Financial Group, answer to question on notice, 28 June 2013 (received 12 July 2013), p. 5.

91 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital Limited*, May 2012, p. xxviii

4.99 The committee believes that the recently legislated reforms to trustees' portfolio holdings disclosure requirements are both necessary and important. It will enable investors to better understand the risks associated with their investment and to monitor how the fund complies with its investment strategy. A similar requirement could be imposed on managed investment schemes.

Chapter 5

Further topics of discussion at the gatekeeper roundtable

5.1 This chapter presents a range of other topics that were considered during the roundtable, including:

- regulation of the self-managed superannuation fund (SMSF) sector;
- integrated reporting;
- the granting of an Australian Financial Services Licence (AFSL);
- detecting fraud;
- the challenges and opportunities of new communications technology;
- the merits and disadvantages of passive index funds versus active asset management; and
- the balance between market efficiency and investor protection in the financial services system.

Self-managed super funds

Regulatory frameworks for self-managed superannuation

5.2 There are crucial differences in the levels of responsibility and risk between the registrable superannuation entities (RSEs) regulated by the Australian Prudential Regulation Authority (APRA) and SMSFs that are regulated by the Australian Taxation Office (ATO). An APRA-regulated superannuation fund has a board of trustees and the members are eligible for compensation in the event of fraud or theft. This is not the case for an SMSF where the members are the trustees and must take personal responsibility for the management and protection of their assets.

5.3 van Eyk argued there was a discrepancy between the regulation in the financial planning sector which operates under model portfolios, platforms overseen by responsible entities (REs), and boards of directors in the case of the regulated superannuation sector, and the minimal regulation of advice provided to SMSFs:

> if you compare the regulation required around providing advice in the self-managed space, it is far less than it is for the financial planning industry, which operates under this model portfolio approved investment list, which is typically off platforms that have responsible entities and which have higher levels of governance, if it is superannuation. There are independent boards that sit for products to come on and off. There are limitations around single-purpose hedge funds. There are limitations around leverage et cetera.

> If you are looking for gaps in the system, I would say that the largest gap that you have at the moment would be around the regulation of self-managed super funds.[1]

5.4 The Financial Services Council (FSC) gave a comprehensive update on the state of regulation in the SMSF sector, including recent changes pertaining to recognised accountants. It stressed that the essential differences in levels of responsibility, risk and protection between APRA-regulated and self-managed superannuation funds need to be communicated clearly in order to avoid an expectation gap regarding the level of oversight in the SMSF sector:

> The SMSF regulatory regime, primarily overseen by the ATO, is largely distinct from the regime that applies to APRA regulated funds. This reflects the nature of the two types of funds – one where a third-party trustee is responsible for members' monies and the other where the member takes personal responsibility for the management of their own money.
>
> As a result, the respective regulatory frameworks are also very different – as are the dynamics of each sector, most obviously in terms of the number of each type of fund. There are only a few hundred funds overseen by APRA versus over 470,000 SMSFs overseen primarily by the ATO.
>
> It is not possible for there to be the same level of oversight of over 470,000 funds as there is over only a few hundred. It is arguably also not appropriate for there to be the same level of oversight given the key distinction between these funds – self managed versus third-party managed. Nevertheless, this may in itself give rise to an expectations gap if there is an assumption that the same level of oversight exists.
>
> The FSC believes that this is the central distinction that should be conveyed to individuals who seek to establish or are advised to establish a SMSF. The key differences in levels of responsibility, risk and protection between self-managing your superannuation via an SMSF or relying on a third-party APRA regulated trustee to oversee your superannuation.
>
> Beyond this, the most commonly cited regulatory gap in relation to SMSFs has traditionally been the carve-out for accountants under the Corporations Act which allowed them to provide SMSF establishment advice without being subject to the relevant protections under Chapter 7 of that Act.
>
> However, as part of the Future of Financial Advice (FoFA) reforms, the *Corporations Amendment Regulation 2013 (No. 3) Select Legislative Instrument No. 101, 2013* requires recognised accountants to be Licensed to provide financial services such as advice on financial products. The regulation now brings recognised accountants within the Corporations Act (and FoFA), closing the regulatory gap and improving the quality of advice that SMSF trustees will receive in the future.

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1 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 19.

> In addition, the FoFA reforms impose a number of higher conduct requirements on all Australian Financial Services License holders who provide financial services including the provision of financial advice. The reforms include a statutory best interest duty and a ban on conflicted remuneration along with various new disclosure requirements.
>
> Finally, a further strengthening of the regulatory framework in relation to SMSFs was the recent introduction of a requirement for SMSF auditors to register with ASIC. To be successfully registered, auditors are required to pass a competency exam, have certain educational qualifications and supervised experience.
>
> Notwithstanding the perceptions and/or expectations gaps, the FSC is of the view that it is important to analyse the impact all of these reforms will have on the uptake of SMSFs, and the types of individuals who decide to establish SMSFs, before determining that further regulatory change is required.[2]

5.5 Ms Volpato from the Australian Institute of Superannuation Trustees (AIST) said that the most effective way to communicate with investors about the risks involved with SMSFs would be for financial planners and financial advisers to have an official leaflet to hand to investors clearly stating that people setting up an SMSF do so at their own risk. She argued that placing the same information on the ATO website would not be as useful because there is no guarantee that investors would receive the information.[3]

5.6 The committee believes that both options are important. It recommended in its report into the collapse of Trio Capital that the ATO include a warning on its website that SMSFs are not covered in the event of theft. The committee notes that the ATO has posted information on its website explaining that 'SMSF trustees have fewer avenues of recourse against fraud and theft compared with trustees of APRA-regulated super funds'.[4] However, the warning is not prominently placed on the website.

5.7 Ms Nerida Cole, Managing Director of Financial Advisory at Dixon Advisory pointed out that SMSF trustees must sign an ATO declaration acknowledging the SMSF sector has limited access to compensation arrangements:

> …my understanding is that it is a requirement of the ATO for trustees to sign a declaration upon commencing a self-managed super fund, which lists

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2 Financial Services Council, answer to question on notice, 28 June 2013 (received 17 July 2013).

3 Ms Karen Volpato, Senior Policy Adviser, Australian Institute of Superannuation Trustees, *Proof Committee Hansard*, 21 June 2013, p. 4.

4 Australian Taxation Office, 'Legal Protection for SMSFs', http://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/News/General-information/Legal-protection-for-SMSFs/ (accessed 19 July 2013).

> a number of specific risks including the limitations for the compensation scheme arrangements that they have access to and that must be signed before they can commence a self-managed super fund. That is certainly a process amongst other disclosure and education requirements that we try to go through with our trustees before they commence the self-managed super fund.[5]

5.8 One Investment Group thought that public expectations around SMSFs may be unrealistic. Mr Epstein questioned the ability of the average Australian to run an SMSF, emphasised the need for portfolio diversity, and suggested the requirements to establish an SMSF should be set higher:

> We have to question whether the hurdles for an individual to run a SMSF are high enough. I do not think that an investor can invest in any product without reading anything and assume that the product is going to be a good product. I do not think it is reasonable to expect that an average Australian can actually run an SMSF. If we relate it back to the property comment and expect that they are going to only invest in property, I do not think that that is a diversified portfolio that warrants the investor investing on that basis.[6]

5.9 Ms Cole said that as a financial planner, she would be very concerned that any SMSF would place all their funds into one asset:

> any SMSF that would have 100 per cent of their funds in one single asset is taking on an extreme amount of risk and would not be something that a prudent investor or adviser would be normally recommending.[7]

5.10 CPA Australia agreed that the best interest duty required a financial planner or adviser to recommend a structure that is appropriate for the client and their desires. Mr Amir Ghandar, Policy Adviser at CPA, noted that SMSFs will likely be a key vehicle for many investors, but also noted that APRA-regulated funds are now offering greater flexibility for people to choose their investment portfolios:

> So, if the client is interested in property—and as we know, that is a large part of Australian culture—and wants to invest in direct property, then SMSF is probably the only vehicle that provides them with that capability.
>
> With regard to the question around the desire to invest in direct equities, that again, probably, has traditionally been the domain of the self-managed super fund, although it is interesting to see APRA-regulated funds now moving into that capability. To me it boils down to the point that, as long as the adviser is acting in the best interest of the client, the SMSF has a

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5 Ms Nerida Cole, Managing Director, Financial Advisory, Dixon Advisory, *Proof Committee Hansard*, 21 June 2013, p. 9.

6 Mr Justin Epstein, Executive Director, One Investment Group, *Proof Committee Hansard*, 21 June 2013, p. 9.

7 Ms Nerida Cole, Managing Director, Financial Advisory, Dixon Advisory, *Proof Committee Hansard*, 21 June 2013, p. 19.

> valuable part to play, if that is the desire of the client in terms of the way they want to invest.[8]

5.11 Ms Volpato agreed with the Future of Financial Advice (FOFA) process and the best interest duty as it relates to SMSFs, but argued that a key deficiency in the current process is the lack of understanding that a client has about what is actually recommended in the statement of advice. She proposed that advice should be formatted in a manner that people could easily understand, and that this approach should be tested on the end-users.[9]

5.12 Ernst & Young agreed 'that the overall framework associated with self-managed super is not as robust' as the APRA-regulated sector, but he noted (as mentioned earlier by the FSC) that ASIC has introduced a registration requirement for external auditors of SMSFs that operates from 1 July 2013. Mr McKenzie said that standards for SMSF auditors have risen, and that the registration requirement appears to have significantly reduced the number of auditors qualified to sign off on SMSFs.[10]

5.13 The AIST raised a series of concerns about the SMSF sector. It emphasised the importance of the safety of superannuation savings, noted that rigorous governance is required for all superannuation monies, and stated that:

> Expectations of and behaviours within SMSFs should, so far as possible, be placed on a level playing field with the rigorously governed APRA regulated funds.[11]

5.14 In support of this, the AIST made a series of recommendations for both the decision-making stage of establishing an SMSF, and for when an SMSF is operating:

> Stage 1—Decision making phase of establishing an SMSF
>
> - The current accountant's licensing exemption of 3 years to 1 July 2016 to provide advice regarding SMSFs should be removed, or at a minimum brought back to 6 months;
> - AIST welcomes the Moneysmart Self Managed Super June 2013 fact sheet. AIST recommends investigating how to ensure that distribution of this fact sheet to a client is a requirement where an accountant or financial planner is recommending establishment of an SMSF. AIST notes that the current requirement that potential SMSF new trustees must sign a form saying they are

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8 Mr Amir Ghandar, Policy Adviser, Audit and Assurance, CPA Australia, *Proof Committee Hansard*, 21 June 2013, p. 21.

9 Ms Karen Volpato, Senior Policy Adviser, Australian Institute of Superannuation Trustees, *Proof Committee Hansard*, 21 June 2013, p. 20.

10 Mr Graeme McKenzie, Partner and Global Head of Pensions, Ernst and Young, *Proof Committee Hansard*, 21 June 2013, p. 19.

11 Australian Institute of Superannuation Trustees, answer to question on notice, 28 June 2013 (received 18 July 2013), p [2].

aware of their responsibilities insufficiently highlights the lack of regulator coverage. A warning from the regulator would have more weight; and

- SMSF trustees must be required to have accredited training prior to establishing an SMSF.

Stage 2—SMSF up and running

- SMSFs will be a major recipient of the efficiency reforms which SuperStream will bring. While AIST believes that these efficiencies will be forthcoming, it is estimated that the cost of implementing these reforms is $467 million. However, it is APRA regulated funds which will bear these costs. AIST recommends that SMSFs should also be required to bear some of these costs, since they participate in the system; and
- SMSF trustees must be required to continue accredited training each year while managing.[12]

Integrated reporting

5.15 The usefulness of audits and company reports has been a key challenge for investors in deciding on their investment strategies. The committee notes that on 20 February 2013 in the *Australian Financial Review*, Luke Sayers, Chief Executive Officer of PricewaterhouseCoopers Australia, said that as the complexity of issues facing business grows, an expectation gap has arisen between what auditors do and what market participants assume or expect from an audit. Mr Sayers said that in order to 'maintain its relevance, the audit profession needs to acknowledge this expectation gap and look for ways to formally adapt the scope of what we do'.[13]

5.16 One initiative intended to address the challenge of meaningful information is integrated reporting (IR). IR is a new corporate reporting model being developed at a global level by businesses and investors. CPA Australia has indicated that the instigation of integrated reporting on a global scale offers the prospect of presenting relevant information including 'increasingly complex business models and systems' to the investor in an easily digestible format.[14]

5.17 IR is designed to support 'better decision-making by providers of financial capital'.[15] According to Mr Paul Druckman, Chief Executive Officer of the International Integrated Reporting Council (IIRC):

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12 Australian Institute of Superannuation Trustees, answer to question on notice, 28 June 2013 (received 18 July 2013), pp [2–3].

13 Mr Luke Sayers, Chief Executive Officer, PricewaterhouseCoopers Australia, 'Auditor's role needs to evolve', *Australian Financial Review*, 20 February 2013.

14 Mr Amir Ghandar, Policy Adviser, Audit and Assurance, CPA Australia, *Proof Committee Hansard*, 21 June 2013, pp 21–22.

15 International Integrated Reporting Council, Integrated Reporting—Business leaders: what you need to know, p. [2], http://www.theiirc.org/wp-content/uploads/2013/04/Business-Leaders-What-you-need-to-know-English.pdf (accessed 16 July 2013).

> IR is the essential next step in the corporate reporting journey. It anchors the reporting process in a more meaningful expression of how value is created which is helpful in attracting investment. It also focuses businesses and investors on the short, medium and long term factors that are vital to achieving the macro aims of financial stability and sustainability.[16]

5.18 IR and the benefits that it offers to investors were explained by CPA Australia as follows:

> Integrated reporting or IR is a comprehensive framework to concisely communicate varied and often complex aspects of organisations, normally contained within multiple reports and other sources, in a unified and holistic way that investors can understand, and that is practically useful in informing their decision making. Importantly, IR responds to the growing need for insight into business models, risks and future prospects which have been highlighted in discussions of expectation gaps of the Committee and more broadly.
>
> An integrated report is defined in the Consultation Draft of the International IR Framework as a concise communication about how an organisation's strategy, governance, performance and prospects lead to the creation of value over the short, medium and long term.
>
> The advantages of IR for both professional and non-professional investors include:
>
> - a deeper and wider understanding of organisational practices, performance and prospects and improved long-term allocation of capital in potential or existing investments;
> - more concise and accessible insights into material factors that create value over the short, medium and long term - of particular value to non-professional investors;
> - concise and accessible answers to important questions including:
>   - What does the organisation do and what are the circumstances under which it operates?
>   - How does the organisation's governance structure support its ability to create value in the short, medium and long term?
>   - What are the specific opportunities and risks that affect the organisation’s ability to create value over the short, medium and long term, and how is the organisation dealing with them?
>   - Where does the organisation want to go and how does it intend to get there?
>   - What is the organisation’s business model and to what extent is it resilient?

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16 Mr Paul Druckman, Chief Executive Officer, International Integrated Reporting Council, Integrated Reporting—Business leaders: what you need to know, p. [4].

- To what extent has the organisation achieved its strategic objectives and what are its outcomes?
- What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?

- enhanced performance through the promotion of 'integrated thinking' across organisations implementing IR.[17]

5.19 Mr Alex Malley, Chief Executive Officer of CPA Australia, is a member of the IIRC and his organisation has been extensively involved in the development of IR. In terms of the suggestion by Mr Sayers about adapting the scope of an audit, CPA Australia proposed two developments that would respond to changes in capital markets, the business environment and stakeholder needs:

> 1. reporting needs to evolve in order to give a holistic picture of business impact across the full range of dimensions, including financial, non-financial, governance, management discussion and analysis to provide for a deeper understanding of company practices, performance and prospects and improved long-term allocation of capital;
> 2. auditing will be critical in the reliability and hence usefulness of enhanced reporting. In turn, an established framework for reporting on business models and risks would provide a valid grounding for auditors to fulfil an enhanced role in respect to assurance around these aspects that are central to expectation gaps in regard to the work of auditors.[18]

5.20 CPA Australia notes that the first recommendation above would be substantially addressed by IR and that this could address many of the expectation gaps around the role of auditing. To this end, CPA Australia is pursuing several initiatives including the following:

> CPA Australia has initiated an Australian Research Council linkage project working together with the University of New South Wales and the Institute of Chartered Accountants in Australia which is intended to make a substantial contribution toward the development of assurance in respect to (IR), and hence enable progress regarding this enhanced role.
>
> CPA Australia has incorporated (IR) and a broad range of relevant topics including sustainability and governance into the CPA Program (CPA Australia's core professional qualification) and continued professional development courses for members. CPA Australia is also working with several Australian universities to incorporate such content into undergraduate programs.[19]

17 CPA Australia, answer to question on notice, 28 June 2013 (received 12 July 2013).

18 CPA Australia, answer to question on notice, 28 June 2013 (received 12 July 2013).

19 CPA Australia, answer to question on notice, 28 June 2013 (received 12 July 2013).

Granting of an AFSL

5.21 In its report into the collapse of Trio Capital, the committee noted that ASIC stated that its ability to restrict the entry of a participant into the financial services industry is limited. ASIC drew attention to the low threshold for obtaining an AFSL and the high threshold for it to cancel an AFSL.[20]

5.22 One Investment Group disagreed with this view. It noted that sections 913B, 913B(3), and 914A(1) of the Corporations Act appear to grant ASIC sufficient powers to restrict and revoke the granting of an AFSL. One Investment Group therefore argued that investors rightly have an expectation that ASIC will act to keep out or remove undesirable participants from the financial services system in Australia:

> Accordingly, the expectation of investors in relation to the issuance of an AFSL is justified. That is, the expectation that undesirable individuals or entities are restricted by ASIC from being involved in the financial services sector is a reasonable and appropriate one. In this regard, it would appear that ASIC's interpretation of the Act and specifically the exercise of its powers for issuing and restricting licences falls short of investors' expectations and arguably the intention of the financial services laws.[21]

Fraud

5.23 Many of the participants at the roundtable made several points in relation to fraud:

- it is very rare and is the exception to the rule;[22]
- it is very difficult to detect;[23]
- different gatekeepers perform checks at various points in the system;[24]
- it affects only a tiny fraction of the total funds under management;[25]

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20 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 128.

21 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [2].

22 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 14; Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 15; Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 15.

23 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 14; Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 15.

24 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 14.

- it does not necessarily constitute a gap in the system, but rather a case of illegality which needs to be dealt with through the legal system;[26]
- most people that have lost everything were in undiversified self managed superannuation funds;[27] and
- the RE has the capacity to scrutinise the investment managers and custodians, and select appropriate auditors.[28]

5.24 The FSC noted that Australia has a $2 trillion funds management industry and that the level of regulation and oversight by gatekeepers was an important factor in the low incidence of fraud.

5.25 Lonsec observed out that research houses do not have the capacity to consistently detect fraud or predict market failure:

> Lonsec does not believe that research houses have either the knowledge or the expertise or the resources to accurately and consistently identify fraudulent conduct which may lead to financial product failure. Nor can research houses accurately and consistently predict extraordinary market events which may cause market failure.[29]

5.26 BT Financial Group provided some statistics on the extent of identified fraud within its business and emphasised the gatekeeper responsibilities exercised by the RE:

> In the last four years we have checked this, we have $80 billion of Australian assets looked after under our responsible entity, as well as 1,100 investment funds and 170 investment managers. We have self-identified within all our scrutiny only one evidence of fraud which we were then able to bring to the regulator's attention. It does give it a sense of scale, but I do think it is very important that the responsibility entity has the capacity to scrutinise its service providers to a high degree—and those are the custodians—but they are also responsible for selecting an auditor with

25 Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 15; Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 15.

26 Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 15.

27 Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 15.

28 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 15.

29 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 6.

> sufficient capacity and expertise to understand the nature of the investments that are being audited and so on.[30]

5.27 Fraud involves deliberately deceptive conduct that is by its very nature difficult to detect. This raises several important points. Firstly, auditors and REs play a crucial role in detecting fraud. However, in a situation such as Trio where the directors of the RE are complicit in fraud, the gatekeeper role of the RE can be rendered impotent. This makes it even harder for an external auditor to uncover a well-concealed fraud. This scenario implies that whistleblowers play a very important role in the system by exposing fraud (and other forms of misconduct or illegal activity). Consequently, there needs to be an effective response by regulators to evidence provided by whistleblowers. Furthermore, despite regulations, it is not necessarily possible to prevent illegal activity. Therefore, deterrence is crucial. This means having effective legal and policing mechanisms in place to apprehend, convict, and punish offenders.

Challenges and opportunities of new communication technology

5.28 The committee was keen to see if developments in communication technology were seen as a tool for overcoming literacy issues and possibly for presenting information in multiple languages.[31]

5.29 Ms Cole replied that new technology presented both opportunities and challenges. She drew particular attention to the difficulty that some people may have in distinguishing between information and advice, and that fact that gatekeepers and regulators are looking at this as an issue of concern:

> With regard to accessing advice in different ways, at the moment that is an exciting but also challenging space for advisers. I think FSC has been working, perhaps with ASIC, on some additional guidance around this. The amount of information and the format of what is available on the internet, via YouTube and different web seminars and webinars, for everyday investors to access is incredible. Some of that information goes quite a way along the process to what may be perceived by many investors as giving them advice. That differentiation between what is information and what is advice can be quite hard for them to gather. That will be a very interesting space to watch as well.[32]

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30 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 15.

31 Ms Deborah O'Neill MP, Chair, Corporations and Financial Services Committee, *Proof Committee Hansard*, 21 June 2013, p. 21.

32 Ms Nerida Cole, Managing Director, Financial Advisory, Dixon Advisory, *Proof Committee Hansard*, 21 June 2013, p. 21.

5.30 Ms Deborah O'Neill MP, Chair of the Corporations and Financial Services Committee, emphasised the importance of quality advice by pointing out that an investor may not always understand what is being advised at the time it is given:

> As a former teacher, I know that there can be a very big gap between the delivery of information and the receipt of the same. Often we do not pay attention until we have to, and sometimes that can be long after the money is invested, hence the importance of the quality of the advice.[33]

Index funds versus active management

5.31 As noted in chapter 2, the committee questioned the fund managers at the hearing about an American economist's claim that over the last 30 years, passively-held index funds had substantially out-performed the average active fund manager. BT Financial Group gave a comprehensive response, which is provided in Appendix 2. It noted that unlike a passive approach, an active approach can enhance risk adjusted returns, exploit pricing anomalies, pursue value investing strategies, engage in downside risk management, pursue different strategies at different periods in the market cycle, and consider the specific outcomes required by the investor. An active managed, it argued, 'needs to be good at picking stocks and also ensure the portfolio is appropriately diversified'.[34] BT noted that its active investment strategy has out-performed a passive benchmark over the last ten years.

The balance between market efficiency and investor protection

5.32 Australia's financial services regulatory system aims for efficiency, flexibility, competition, innovation and a low cost of capital. Retail investors have access to a wide range of products, including high-risk products. The system aims to prevent regulatory failure, rather than the failure of financial products. Indeed, as ASIC observed, the failure of a high-risk business strategy and consequent investor loss is an essential part of an efficient market.[35]

5.33 Since the Trio inquiry, ASIC has suggested moving the balance between market efficiency and investor protection more in favour of retail investors. The committee sought the views of business and industry representatives on whether they considered that the balance in Australia between market efficiency and adequate protection for retail investors is right.

5.34 van Eyk observed that excessive regulation and an over-aversion to risk could undermine the end objective which was to ensure that compounded annual returns

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33 Ms Deborah O'Neill MP, Chair, Corporations and Financial Services Committee, *Proof Committee Hansard*, 21 June 2013, p. 21.

34 BT Financial Group, *answer to question on notice*, 28 June 2013 (received 12 July 2013).

35 Australian Securities and Investments Commission, *Submission 51*, p. 14, paragraph 24(c), Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

beat inflation, thereby ensuring that people's superannuation was sufficient to fund their retirement:

> In respect of the comments I made previously around how the retail part of the industry gave advice—and that was a model-driven approach—typically in that there are balanced asset allocations varying in terms of exposure to shares and other risky assets and exposures to bonds, which are supposedly defensive assets and have performed very well in the last five years. There is an issue, though, that presents itself at the moment, and this touches on risk. I was interested in the comments made around trustees having to put their risk profiles in. The superannuation system is essentially unfunded for a lot of Australians. If you step back and you look at what is the issue here that we are trying to drive, it is about a lifestyle in retirement. There are some rogue investments, if I could categorise them in that space, and some of them have actually been in the conservative space. Look at some of those hedge fund strategies: they had very low volatility, which is one measure of risk. The question I would put is that we do not want to let the risk management cruel the end objective and make us take too little risk to meet our compounded annual return in excess of inflation. If we were to look at the current investments, a lot of the exposure is in bond markets, which are yielding one or two per cent, which is very unlikely to beat inflation, which is the real enemy in this whole process. So I would think that the major issue is: what are we doing around the defensive assets? A lot of these hedge fund strategies, which are difficult to look at, do operate in that low-risk space. Are we actually over-regulating in some spaces and not letting the natural course of the markets take its effect?[36]

5.35 CPA Australia said that regardless of how the market is regulated, the key factor is the risk reward balance and supporting investors with the right information that is communicated in an easily understood format:

> However you calibrate the market, investing is still going to be a matter of balancing up risks and rewards. We start with a belief that Australian investors, whether they are retail investors or professional investors, are focused on weighing up those risks and rewards in whatever way. What we can do to support them, what is really critical to do, is provide them with information that they can understand and use in order to make those kinds of decisions. We got onto the topic of too much information versus not enough information. What we need to be focused on, and what I think this forum is really fantastic in highlighting, is the right type of information and the right way of communicating with those stakeholders in a way that actually recognises their needs broadly and also in a way that they can calibrate individually.[37]

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36 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 27.

37 Mr Amir Ghandar, Policy Adviser, Audit and Assurance, CPA Australia, *Proof Committee Hansard*, 21 June 2013, p. 27.

5.36 The FSC argued that in fact the pendulum has already swung towards greater investor protection with the raft of legislation and reforms that have been enacted in recent years.[38]

5.37 BT Financial Group argued that the fundamental factor was risk appetite and getting the correct balance between risk and reward appropriate to the various stages of life. While asset allocation can be done at the individual or household level, Mr Brennan pointed out that BT Financial Group builds cohorts within their superannuation portfolios designed to match various age profiles of client groups. BT Financial Group trustees review the asset allocations within the portfolios on a regular basis, thereby relieving the individual of the need to check their asset allocation. Like Mr Thomas, however, he expressed concern that removing higher risk products may be counter-productive:

> I do believe that the risk appetite is almost pertinent to the individual and the household. It really depends on whether you are at the beginning of life and just starting to build the pot to buy a house before you have got married, before you have got children, or you are at the end and the children have all left and you are about to start drawing down your pension. I think the fundamental to hitting that balance is actually the mix of assets that you hold, which is high-risk assets and low-risk assets. My fear, in the event of trying to go to a higher degree of investor protection, is you remove higher risk assets, which are actually an important part of a youngster's portfolio, perhaps. Then that turns you around to: how does one hit that balance? Unless you are highly versed in the financial markets, it is actually difficult.
>
> One of the ways we do it in our superannuation product, our Super for Life, is we build cohorts within the portfolio so that if you are born in the 2000s, and therefore relatively young, the asset allocation is struck accordingly. Then as you get older the asset allocation is adjusted until you are approaching retirement and has much more lower risk assets. The trustees overview that asset allocation every six months to every year to ensure that it is operating as designed. By that method we try to glide people through to retirement in the best possible way. It also means that they can pretty much switch off that responsibility for how their assets are mixed. But for us to do that we actually need high-risk assets in the system. Does that make sense? There are two ways you can do it. You can do it as a household, or you can do it as a trustee on behalf of people who have gone into default—they have actually checked out of the decision.[39]

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38 Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 27.

39 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 28.

Committee view

5.38 This report has presented evidence on a range of issues relating to the role of the 'gatekeepers' in Australia's financial system—financial planners, research houses, RSE trustees, custodians, auditors and REs. The gatekeepers play a crucial role within this system to meet the overarching objective of protecting consumers, investors and creditors. ASIC enforces the Corporations Act and provides regulatory guidance to market participants. It is also responsible for maintaining gatekeepers' standards. In recent times, it has told research houses, auditors and some financial advisory firms that they need to improve their standards.

5.39 The gatekeepers are expected to self-regulate; to perform their respective functions according to the statutory requirements and in so doing provide investors and creditors with confidence that their interests are protected. It was of concern, therefore, that a consistent theme of the committee's inquiry into the collapse of Trio Capital was the gap in expectation between what was legally required of the gatekeepers and what investors and creditors thought was the gatekeepers' role.

5.40 The purpose of the committee's roundtable in June 2013 was to examine what each of the six gatekeepers viewed as their role, how they perceive the role and responsibilities of other gatekeepers, and how they interact. Chapters 3 and 4 of this report provided two angles to examine these complex interactions. Chapter 3 focused on the business model of research houses, and their interactions with financial planners / financial advisers and fund managers. Chapter 4 looked at how assets are valued and verified and the portfolio disclosure of managed investment schemes. Here, the focus was on the interactions between custodians, REs, trustees, and the auditors of RSEs and REs.

5.41 There is considerable evidence in both chapters 3 and 4 that the committee found very useful. It identifies the different business models used within gatekeeper groups (such as research houses) and areas of potential tension and misunderstanding between gatekeepers. Above all, the committee hopes that the roundtable and the information it has provided on the public record has generated interest—and areas for further discussion—among the various gatekeepers, their professional bodies and the wider investment community. It is important that there are future deliberative opportunities for the gatekeepers to engage with ASIC and the parliamentary process.

5.42 Over the term of this parliament, the committee has increased its ASIC oversight hearings from two to four per year. It has also used the oversight process to take evidence from a range of other stakeholders including the AUASB, the Financial Reporting Council and the Australian Stock Exchange, as well as the gatekeepers at the June 2013 roundtable. The greater focus on the committee's oversight process has been very useful: it has raised the committee's profile; allowed it to monitor ASIC's progress during a period of significant reform in the financial advice sector; focussed attention on gaps between what is expected of gatekeepers and ASIC and what they are actually required to do; and developed the committee's understanding of emerging

regulatory issues such as high-frequency trading and dark pools, and events such as the collapses of Banksia and Wickham Securities.

Recommendation 5.1

5.43 The committee recommends that the Parliamentary Joint Committee on Corporations and Financial Services in the next parliament continues to use the ASIC oversight process to monitor ASIC's activities regularly and closely, and raise the public's awareness of the roles and performance of the gatekeepers and statutory bodies in Australia's financial system. The committee believes that this forum is ideal for ASIC itself to clarify publicly what it does and does not do, and explain areas of emerging and ongoing regulatory concern.

Ms Deborah O'Neill MP
Chair

Appendix 1

Public hearings and witnesses

Sydney, 21 June 2013

Australian Custodial Services Association

Mr Pierre Jond, Chairman; Managing Director, BNP Paribas Securities Services
Mr Paul Khoury, Deputy Chairman

Australian Institute of Superannuation Trustees

Ms Karen Volpato, Senior Policy Adviser

Australian Securities and Investments Commission

Mr Peter Kell, Commissioner
Mr Greg Tanzer, Commissioner
Ms Calissa Aldridge, Senior Manager
Ms Cathie Armour, Commissioner

BT Financial Group

Mr Royce Brennan, General Manager, Risk

CPA Australia

Mr Amir Ghandar, Policy Adviser, Audit and Assurance

Dixon Advisory

Ms Nerida Cole, Managing Director, Financial Advisory

Ernst & Young

Mr Graeme McKenzie, Partner

Financial Services Council

Ms Eve Brown, Senior Policy Manager, Trustees
Mr Martin Codina, Director, Policy

Lonsec Research

Mr Richard Everingham, General Manager, Strategy and Development

Macquarie Group Ltd

Mr Anthony Graham, Executive Director

One Investment Group

Mr Justin Epstein, Executive Director

van Eyk Research Pty Ltd

Mr Mark Thomas, Chief Executive Officer

The roundtable participants

Lonsec Research Pty Ltd (Lonsec)

Lonsec, and its predecessor Lonsdale Securities, has been a provider of investment research to the Australian financial intermediary market since 1993. Lonsec is a market leader in the unlisted (managed funds) research segment. For the past three years Lonsec has been voted the number one research house (both by users of investment research and financial product issuers) for managed funds research.[1]

Lonsec began as part of a licensed financial planning dealer group, but is now a stand-alone business. It offers research on listed and unlisted investments, stockbroking services to financial advisers, equity model portfolios and investment consulting services.[2]

van Eyk Research

van Eyk is an independently owned financial services group established in 1989. van Eyk does not accept fees for rating fund managers, and its investment research is only available on a 'user pays' subscription basis to financial planners.

1 Lonsec, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013; Money Management, Lonsec named research house of the year for 2012, http://www.moneymanagement.com.au/analysis/rate-the-raters/lonsec-named-research-house-of-the-year-for-2012 (accessed 11 July 2013).

2 Lonsec, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013; Lonsec, Lonsec services, http://www.lonsec.com.au/aspx/Public/General/Services.aspx (accessed 11 July 2013).

Van Eyk covers traditional sectors such as Australian equities, smaller companies, international equities and fixed interest, as well as alternative sectors like hedge funds and commodities. Van Eyk ratings are based on in-depth qualitative research.[3]

Dixon Advisory

Dixon Advisory is an independently-owned Australian financial advisory firm. It was founded in 1986 by Daryl Dixon. Dixon Advisory helps in excess of 15,000 families with their superannuation and financial affairs including over 4,000 with self-managed super funds (SMSFs) with a combined asset base in excess of $4 billion.[4]

Dixon Advisory offers financial strategy advice, SMSF administration, investment advice, estate planning advice and wills drafting, personal insurance advice, and property advice. Dixon Advisory is also the RE for the US Masters Residential Property Fund which provides investors with the opportunity to gain exposure to a diversified portfolio of US-based residential property assets.[5]

Dixon Advisory was rated by *Financial Review Smart Investor* as the number one SMSF provider in 2012 and 2011, and won the *Australian Business Award* Service Excellence in 2013 and 2012.

Macquarie Group Limited

Macquarie Group Limited, through its Banking and Financial Services Group (BFS), operates in the retail financial services industry at many levels and as both a provider of financial services and financial products.

Macquarie Adviser Services (MAS) is a division within BFS that primarily distributes financial products and services through intermediaries. MAS deals with financial planners and financial advisers who have their own AFS licences, or are representatives of AFS licensees.

Macquarie Private Wealth (MPW) is another division in BFS that provides financial advising and broking services. Macquarie Group employs financial planners and financial advisers in its MPW business, and it provides financial services under a Macquarie AFS licence.

Different Macquarie Group licensed entities also perform trustee, custodial and RE functions.

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3 Van Eyk, Investment research, http://www.vaneyk.com.au/index.cfm (accessed 11 July 2013).

4 Dixon Advisory, About Dixon Advisory, http://www.dixon.com.au/About-us/About-us.aspx (accessed 11 July 2013).

5 Dixon Advisory, Dixon Advisory Services, http://www.dixon.com.au/Services/Services.aspx (accessed 11 July 2013).

Australian Custodial Services Organisation

The Australian Custodial Services Association Limited (ACSA) is the peak industry body representing members of Australia's custodial and investment administration sector. Formed in 1994, ACSA represents members holding securities in excess of $1.8 trillion in custody and under administration.

ACSA's aim is to contribute to innovation within Australia's investment administration infrastructure, support the development of custody professionals, and to provide leadership in representing its members.[6]

Major activities are accomplished by a series of ACSA working groups in the areas of taxation, regulation and compliance, custody operations, corporate actions, professional development, communications, and administration.[7]

Australian Institute of Superannuation Trustees

The Australian Institute of Superannuation Trustees (AIST) is an independent, not-for-profit professional body. It is the principal advocate and peak representative body for the not-for-profit superannuation sector. Its members are the trustee directors and staff of industry, corporate and public-sector superannuation funds, who manage the superannuation accounts of two-thirds of the Australian workforce.

AIST's mission is to protect the interests of Australia's $500 billion not-for-profit superannuation sector. It plays a key role in policy development, and is a leading provider of research. As a registered training organisation, AIST provides professional training, compliance and consulting services, and support for trustees and fund staff.[8]

Financial Services Council

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees.

The members of the FSC are Australia's leading wealth managers with responsibility for managing savings and facilitating investment. The FSC advocates on behalf of its members and contributes to macro-economic policy issues.

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6 Australian Custodial Services Association, about ACSA, http://www.custodial.org.au/public_panel/aboutacsa.php (accessed 11 July 2013).

7 Australian Custodial Services Association, Working groups, http://www.custodial.org.au/public_panel/workinggroups.php (accessed 11 July 2013).

8 Australian Institute of Superannuation Trustees, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013; Australian Institute of Superannuation Trustees, Who are we?, http://www.aist.asn.au/about/who-are-we.aspx (accessed 11 July 2013)

Key priorities for the FSC include improving the well-being of all Australians; promoting financial adequacy for all Australians; increasing consumer confidence in the financial services industry; promoting efficiency, integrity and good regulation; and improving the professionalism and success of the FSC and its members. The FSC has been a prominent stakeholder in discussions on the FOFA legislation.[9]

BT Financial Group

BT Financial Group is the wealth management arm of the Westpac Group, which, following the Westpac and St George merger in late 2008, also includes the wealth division of St George bank.

BT Financial Group offers a wide spectrum of wealth services including investment, superannuation and retirement income products, investment platforms, financial advice, private banking and insurance solutions.

Key brands in the group include Advance, Ascalon Capital Managers, Asgard, BankSA Financial Planning and Insurance, BT, BT Investment Management (60 per cent owned by Westpac Group), Licensee Select, Magnitude, Securitor, St.George: Financial Planning, Insurance and Private Clients, and Westpac: Financial Planning, Insurance, and Private Bank.[10]

One Investment Group

One Investment Group is an independent Australian funds management business established to provide RE, trustee, corporate trust, custody and fund administration services. One Investment Group specialises in a range of asset classes including real estate, private equity, infrastructure, equity, mortgage and hedge funds.

Entities within One Investment Group currently operate as RE of numerous registered schemes and as trustee of more than 100 unregistered schemes. The total value of assets within these schemes is in excess of $3 billion.[11]

One Investment Group also has four entities which provide financial and investment advice to corporations, financial institutions and public sector clients.[12]

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9 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013; Financial Services Council, About us, http://www.fsc.org.au/about-us/about-the-financial-services-council.aspx (accessed 11 July 2013).

10 BT Financial Group, Who we are, http://www.btfg.com.au/about-bt-financial-group/who-we-are/who-we-are.asp (accessed 11 July 2013).

11 One Investment Group, Company overview, http://oneinvestment.com.au/about/ (accessed 11 July 2013).

12 One Investment Group, Advisory services, http://oneinvestment.com.au/services/advisory-services/ (accessed 11 July 2013).

Ernst & Young

Arthur Young & Company was formed in 1906, and Ernst & Ernst was formed in 1903. In 1989, the firms combined to create Ernst & Young. Ernst & Young is a global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. The business units are grouped into four geographic Areas: the Americas; Asia-Pacific; Europe, Middle East, India and Africa; and Japan.

Ernst & Young provides auditing, assurance, and tax services. It also offers advisory services in areas including capital transactions, productivity and performance.[13]

CPA Australia

CPA Australia is one of the world's largest accounting bodies with a membership of more than 144,000 finance, accounting and business professionals in 127 countries across the globe.

Core services to members include education, training, technical support and advocacy. Staff and members work together with local and international bodies to represent the views and concerns of the profession to governments, regulators, industries, academia and the general public.

A Certified Practising Accountant (CPA) is a finance, accounting and business professional with a specific qualification. The CPA designation is a mark of high professional competence.[14]

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13 Ernst and Young, Services, http://www.ey.com/AU/en/Services (accessed 11 July 2013).

14 CPA Australia, About us, http://www.cpaaustralia.com.au/cps/rde/xchg/cpa-site/hs.xsl/about.html (accessed 11 July 2013).

Appendix 2

Answers to questions on notice

Australian Securities and Investments Commission: answers to questions taken on notice 21 June 2013, received 23 and 24 July 2013

Question 1

Would the committee be able to receive, either in public or in camera, a copy of the legal advice that ASIC has received which doubts the likelihood of a successful prosecution against Mr Maher (formerly Gresham)?

Answer

The legal advice that was referred to by ASIC during its hearing before the Committee was advice about whether ASIC was in a position to seek orders preventing Mr Maher from travelling. ASIC has advice from Senior Counsel that it does not have reasonable grounds for bringing such an application.

ASIC is not in a position to provide a copy of Senior Counsel's legal advice to the Committee as we are concerned that to do so would waive legal professional privilege. ASIC is very reluctant to waive privilege in circumstances where we have an ongoing investigation of Mr Maher.

Question 2

Does ASIC have a view as to whether Mr Maher has purchased assets with the $2 million dollars that he received in undisclosed commissions from recommending the ARP Growth Fund and PPST?

Answer

In responding to this question we are presuming that the Committee is referring to approximately $2 million dollars in undisclosed commissions that Mr Maher received for recommending certain investments for PPPST.

As indicated previously, ASIC has not identified Mr Maher as owning any assets of any substance that could be pursued to recover funds for investors. In addition, ASIC is not aware of the liquidators of Trio Capital Ltd (in liquidation) finding any such assets.

Question 3

In its submission to the Trio inquiry, ASIC noted that the assurance standards that are relevant to a compliance plan audit do not have the force of law. ASIC suggested possible reforms to improve the effectiveness of compliance plans, auditors and committees. This included introducing an approval process for compliance plan auditors and civil liability provision for compliance plan audits.

a) What progress has ASIC made in this area and what feedback have you had from stakeholders?

Answer

Introducing an approval process for compliance plan auditors and civil liability auditors is a policy matter for government.

We are consulting with the Auditing and Assurance Standards Board (AUASB) concerning a possible update of its guidance for compliance plan audits in GS 013 Special Considerations in the Audit of Compliance Plans of Managed Investment Schemes (GS 013), which was issued in August 2009. We wrote to the AUASB in November 2012 with the following matters:

(a) Form of revised pronouncement:

We recognise that the Board has issued GS 013 as a guidance statement because it:

(i) is largely a restatement of the law and ASIC guidance; and

(ii) is underpinned by the auditing and assurance standards.

Should the revised pronouncement include any additional requirements specific to compliance plan audits, the Board may wish to consider issuing a standard. While a standard would not have the force of law, it would be mandatory for members of The Institute of Chartered Accountants in Australia, CPA Australia and the Institute of Public Accountants.

(b) Revised ASIC regulatory guide:

ASIC intends to issue a revised regulatory guide RG 132 Managed Investments: Compliance Plans (RG 132) to provide enhanced guidance as to our expectations for the content of compliance plans. The revised RG 132 may also incorporate the guidance current in regulatory guides RG 116 to 120. The Board should consider the revised RG 132 in developing its revised pronouncement.

(c) Materiality:

The existing guidance on applying materiality in reporting by the auditor of non-compliances with a compliance plan resides in an ASIC Information Sheet. Recognising that reporting immaterial matters could detract from the identification of material non-compliances, we intend to continue this guidance but may include it in a regulatory guide.

(d) Other ASIC regulatory guides:

Since GS 013 was issued, ASIC has issued a number of regulatory guides that are relevant to specific types of registered schemes. The AUASB should consider the extent to which the following regulatory guides impact on the role of the auditor and should be addressed in an updated pronouncement, an updated GS 014 Auditing Mortgage Schemes or a separate new pronouncement. These regulatory guides are:

(i) RG 46 unlisted property schemes—improving disclosure for retail investors;

(ii) RG 45 mortgage schemes—improving disclosure for retail investors;

(iii) RG 231 infrastructure entities—improving disclosure for retail investors;

(iv) RG 232 agribusiness managed investment schemes—improving disclosure for retail investors; and

(v) RG 240 hedge funds—improving disclosure.

(e) ASIC audit firm inspection programme findings:

The Board should consider the extent to which findings concerning compliance plan audits that have been identified in ASIC's inspection of audit firms indicate matters that could be addressed in a revised pronouncement. These are outlined in our last public audit inspection report (Report 317 Audit Inspection Program Report 2011–12). While the matters identified by ASIC concern compliance by auditors with their existing obligations, AUASB standards or guidance may assist auditors in better understanding their obligations and conducting quality audits.

Some specific findings from our audit firm inspections are:

(i) Performing compliance testing only for selected schemes managed by a single responsible entity without due regard to differences between schemes and the controls operating for each scheme;

(ii) Failure by auditors of registered schemes relying on the report of an auditor of a custodian to ensure that the report addresses relevant aspects of compliance with the compliance plans of those schemes; and

(iii) Audit evidence not being obtained or insufficient documentation of audit evidence obtained.

Question 4

Under section 601HG(2) of the Corporations Act, the auditor of an entity's compliance plan cannot be the auditor of that entity's financial statements, although the auditors may work for the same audit firm. In its submission to the Trio inquiry, KPMG stated that the requirement for different persons to carry out the compliance audit and the audit of the financial statements 'increases disaggregation in the oversight of the MIS'.

(a) What is ASIC's perspective on this?

(b) What does ASIC see as the risks that might arise if the same person were permitted to carry out both types of audit?

Answer

The independence and objectivity of the auditor is an important contributor to audit quality and market confidence in the independence assurance provided by the auditor. Having a separate person within a firm audit the compliance plan to the auditor of the financial report of the responsible entity can only enhance the independence and objectivity of the auditors. The risk and perception that the auditor may be less willing to raise and report concerns in the compliance plan audit to avoid any impact on the relationship with the responsible entity and fees from that entity is reduced.

Question 5

At the time of the Trio inquiry, ASIC observed that Part 5C.4 of the Corporations Act:

- did not impose any qualitative standards by which a compliance plan auditor must conduct their audit;
- did not make it an offence to conduct a poor-quality compliance plan audit;
- only required the auditor to check compliance with the compliance plan, not the compliance of the RE with the constitution of the MIS; and
- unlike the assurance standards for an audit of financial statements, the assurance standards for a compliance plan audit did not have the force of law.

In your submission, ASIC provided a forward work plan which identified regulatory options for improving the quality of compliance plan audits.

(a) Can you outline your progress in each of the above areas since Trio?

(b) Since Trio, has there been a successful action against a compliance plan auditor?

Answer

We continue to review audits of compliance plans as a part of our inspections of audit firms. There have been no successful actions against a compliance plan auditor.

Question 6

As a result of the compliance plan audit inspections undertaken over the last year, has ASIC identified any further areas of systemic concern across the industry?

Answer

In addition to the matters mentioned in response to question 3, our November 2012 letter stated that our public report on audit firm inspections in the 18 months to 30 June 2012 identified the following concerns with compliance plan audits for managed investment schemes conducted under s.601HG(1) of the Corporations Act:

(a) Where functions such as custodial or investment administration or back-office accounting are outsourced, auditors often choose to rely on a report prepared by the auditor of the service organisation reporting on the design, implementation and/or effectiveness of operating controls, or in relation to specific assertions such as valuation and existence of investments.

(b) We found that auditors of compliance plans did not always obtain sufficient and appropriate audit evidence on which to base their conclusions in areas such as:

(i) whether the compliance plan continued to meet the requirements of Pt 5C.4 of the Corporations Act;

(ii) the adequacy of procedures for reporting and assessing breaches of the compliance plan;

(iii) the assessment of whether the service organisation auditor's report could be relied on in relation to outsourced functions, risk assessments performed by the auditors, and the relationship to work performed on areas of the compliance plan audit; and

(iv) the testing of specific areas, such as subsequent events up to the date of issuing the compliance plan audit report, net tangible asset calculations (for the responsible entity), and cash flow projections.

Question 7

Many frauds are undiscovered for some time and may only come to light because of a whistle-blower within the organisation. Directors are often seen as the principal gatekeeper with responsibility for detecting fraud. If the directors are in on the fraud, to what extent would ASIC expect a compliance plan audit to detect fraud?

Answer

A compliance plan audit is not designed to identify fraud. It might identify failure to apply controls which would have helped reduce the risk that the fraud occurred and in this way attract attention to a fraud. If incidentally to a compliance plan audit, the auditor has reason to suspect a fraud that would constitute a contravention of the *Corporations Act 2001*, the auditor may have an obligation to report the matter to ASIC under s.601HG of that Act.

Question 8

Given that a compliance plan auditor is only required to ascertain the compliance of an RE with its compliance plan, could you clarify for the committee who is actually responsible for ensuring that an RE adheres to the constitution of the RE's MIS?

Answer

A compliance plan audit also covers whether the compliance plan itself complies with the Act.

The responsibility for ensuring that a responsible entity adheres to the constitution is with the directors of the responsible entity.

Question 9

During the Trio inquiry, KPMG suggested a need for greater oversight of managed investment schemes. KPMG argued that one option would be to mandate a majority of truly independent directors of the responsible entity which would remove the need for a compliance committee. The second option is to strengthen the role of the compliance committees and hold management accountable for acting on the recommendations of the compliance committee.

(a) Could you comment on these two options?

Answer

The role of the compliance committee concerns the compliance plan and compliance with that plan. The directors have a broader responsibility in relation to the conduct of the overall scheme.

If there is a compliance committee with a majority of independent members with appropriate capacity, powers and duties, it is unclear on what basis there is a need for a majority of independent directors if the objective of the arrangements is to promote compliance.

It would not be appropriate to require officers of the responsible entity to be subject to direction by the compliance committee. Indeed that would undermine the compliance committee's capacity to provide independent oversight. If management is unable to address concerns arising from monitoring by the compliance committee, the compliance committee's function is to report the matter to ASIC.

Question 10

In ASIC's submission to the Trio inquiry, you noted that a MIS can be a complex product and yet there was no specific statutory requirement for the RE of a MIS to disclose its scheme assets at the asset level. This committee also recommended in its Trio report that the government release a consultation paper on this issue, a recommendation that the government has accepted.

(a) Could ASIC update the committee on progress in this area, including whether a consultation paper has been released?

Answer

See below.

Question 11

On 1 July 2013 under the Further MySuper bill, new arrangements come into force. The EM (pp. 39–40) provides the following example:

An RSE licensee (ABC Super) invests assets of their fund through a custodian. The custodian must invest as directed by ABC Super. The custodian, at the direction of ABC Super, invests assets in a financial product provided by Managed Investment scheme 1.

Managed Investment Scheme 1 makes investments into other managed investment schemes. It is a fund of funds.

Managed Investment Scheme 1 invests in a financial product offered by Managed Investment Scheme 2 by purchasing units in that scheme.

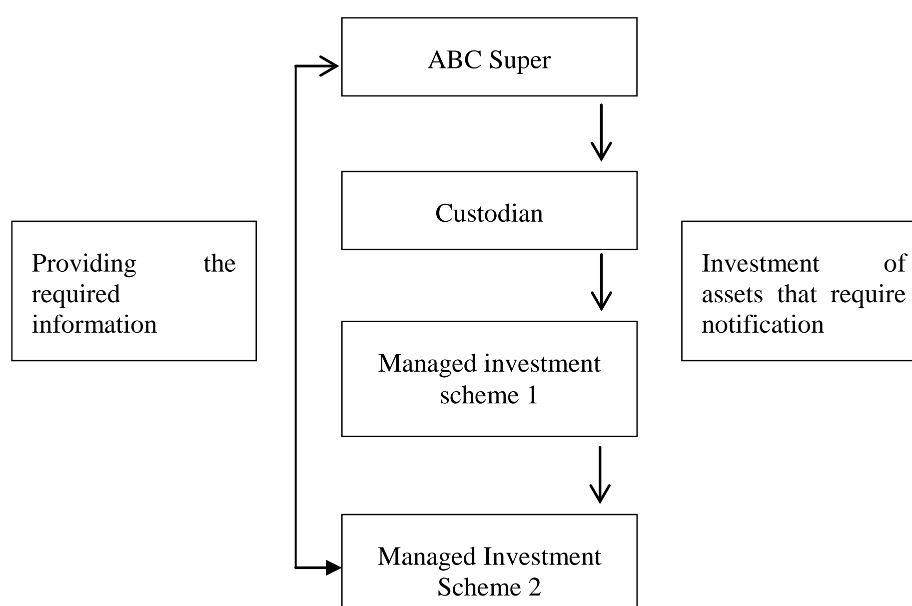
In this example, ABC Super must notify the custodian the assets are those of ABC Super.

The custodian must then notify Managed Investment Scheme 1 that the assets invested are those of ABC Super as it is an investment in a financial product.

Managed Investment Scheme 1 must subsequently notify Managed Investment Scheme 2 that it is investing assets derived from the assets of ABC Super as it is investing in another financial product.

Managed Investment Scheme 2 will have an obligation to provide information directly to ABC Super that is sufficient to identify its financial product and the value of ABC Super's investment.

The steps involved are set out in the Diagram.



(a) How will these arrangements improve the reporting of underlying asset values?

(b) What will these arrangements improve the reporting of underlying asset values?

Answer

See below.

Question 12

The committee understands that reforms proposed in the Further MySuper bill last year will be introduced via regulation and not through the enactment of the bill.

Treasury has begun to consult on the draft regulations. One of the proposed changes revolved around the obligations that were incurred when an MIS invested funds from a superannuation fund into a second MIS. The committee understands that the second MIS would be required to report back to the RSE trustee on its portfolio holdings.

Could you tell the committee whether that obligation would apply if the second MIS was an unregistered overseas fund?

Answers to questions 10, 11 and 12

ASIC has not produced a consultation paper at this stage, in relation to either managed investment scheme or superannuation funds portfolio holdings disclosure. At present, we are waiting for settled legislation, particularly with regards to portfolio holdings disclosure as part of the Stronger Super reforms. We are currently providing feedback and assistance to Treasury on the drafting of regulations in relation to portfolio holdings disclosure. These regulations will give greater detail to the requirements in section 1017BB of the Corporations Act 2001, as inserted by the Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012 (Tranche 3). The Explanatory Memorandum for Tranche 3 is quoted in the question above. The timeframe for this aspect of the Stronger Super reforms has been changed in the Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act (Tranche 4) so that the first reporting date for portfolio holdings disclosure is 90 days after 30 June 2014, as opposed to its original timeframe of 90 days after 31 December 2013.

We may issue further consultation papers or regulatory guidance after these regulations are settled. We anticipate that there may be changes to these proposed regulations from original drafts that were circulated publicly in May 2013, following industry feedback.

In terms of the reporting of asset values, there is a proposed regulation that will enable ASIC to determine how assets should be valued and described: see proposed regulation 7.9.07W. These arrangements may help improve the reporting of underlying asset values as ASIC may be able to impose a consistent methodology for asset valuation.

However, we see the primary function of portfolio holdings disclosure to be increasing consumer awareness of the nature and types of investments being made by trustees with their superannuation monies. This enables people to better understand the risks associated with their investment and to monitor how the fund complies with its stated investment strategy. Greater transparency will also assist consumers to make more informed decisions about their superannuation fund and whether an investment option is suitable.

In the current drafting of the portfolio holdings provisions in Tranche 3, there are look-through arrangements that require managed investment schemes that are invested in by trustees to report back to the trustee as to where the money has ultimately been placed. There are jurisdictional limitations where the fund invested in is offshore. ASIC cannot insist on the offshore fund reporting to the trustee as to where the money has been placed. However, it is expected that the trustee would report the initial offshore investment to the extent that it is known to the trustee.

In the further regulations on portfolio holdings disclosure, there may be changes to the look-through provisions that are detailed in the question above.

We understand that the Government may be interested in extending similar portfolio holdings requirements to managed investment schemes following Trio. ASIC has consistently expressed its full support for this position. We consider that the primary function of portfolio holdings disclosure by superannuation funds, stated above, to apply equally to managed investment schemes.

Further, we remain fully supportive of industry initiatives with regards to improvements in portfolio holdings disclosure.

Question 13

In your submission to the Trio inquiry, ASIC stated that the government might consider banning payments by issuers to research houses for research.

(a) What has caused ASIC to change its position in the recent regulatory guide on research report providers?

(b) Does ASIC have greater concerns about particular types of business model employed by research houses?

Answer (a)

In our consultation paper, CP 171 Strengthening the regulation of research report providers (including research houses) released in November 2012, we consulted on whether conflicts of interest associated with product issuers paying for research: (a) can be effectively and robustly managed; or (b) should be avoided entirely.

We received 27 submissions in response to our CP. In response to our questions on the conflicts associated with issuer pays research, most respondents considered that this conflict could be managed with robust processes and appropriate controls. Many also noted that that there was a range of other business model conflicts that can have similarly adverse impacts on the quality, integrity and reliability of the research. Some respondents also noted that requiring avoidance of this conflict may have an adverse impact on the availability of research in the current market.

On consideration of the issues and submissions, our updated guidance requires providers who operate issuer pays business models to maintain robust controls to ensure fee and contractual arrangements, relationship management and /or ancillary business units are kept separate from the ratings process and outcome. We also expect clear disclosures for users of research that the research was commissioned and paid for by the issuer.

Our expectations of conflicts management for both direct and indirect business model conflicts is set out in Table 5 of Regulatory Guide 79 Research report providers: Improving the quality of investment research (RG 79). On releasing our updated guidance, we also committed to conducting targeted surveillance of research report providers to assess compliance with our updated guidance, measuring both broad compliance as well as discrete issues such as conflicts management. We have given a clear signal to industry that if standards do not improve, we will revisit the regulation of research report providers to consider whether specific law reform is needed. Further, we have also said to industry that if as an outcome of our surveillance activity, conflicts of interest for example, are not being managed appropriately; we will take regulatory action and if necessary, revisit the need to suggest law reform in relation to this sector.

Answer (b)

Different conflicts of interest are present or can arise across the spectrum of business models adopted by research providers. We recognise that the structure of a business can increase or reduce the incidence of conflicts of interest and expect research providers to consider the impact of conflicts in choosing their business model. We expect each provider to consider real and perceived conflicts of interest and where appropriate to manage the conflict with robust controls. Where conflicts of interest cannot be managed, we expect providers to avoid the conflict entirely. The effectiveness of these arrangements will be the subject of ASIC's surveillance activity.

Question 14

Does ASIC view research houses as providers of financial advice or as providers of information?

Answer

RG79.25 sets out what we consider to be a research report. We consider that a research report:

- is general advice that is in writing;
- includes an express or implicit opinion or recommendation about a named or readily identifiable investment product; and

- is intended to be, or could reasonably be regarded as being intended to be, broadly distributed (whether directly or indirectly) to clients (whether wholesale or retail) in Australia.

Question 15

Some participants at the ASIC Annual Forum expressed a desire to see research houses have more 'skin in the game' and face greater accountability for the quality of their research.

(a) Does ASIC believe that research houses have enough 'skin in the game'

(b) Is ASIC comfortable with the level of accountability to which research houses are currently subjected?

Answer (a)

Research is prepared and distributed to retail and wholesale clients and is an important input into the quality of financial advice retail investors receive. It is a commercial imperative for research providers to deliver research services that their clients can have confidence in. The changes we have made to our policy to improve the quality of investment research in RG 79, which comes into effect on 1 September 2013, are designed to assist wholesale clients, such as advisory businesses, to do their own due diligence on potential third party service providers such as research providers. Where the service offering is not of good quality or where conflicts of interest are not effectively managed, we expect purchasers of research services to 'vote with their feet' and choose alternative providers who can deliver quality, reliable services.

Answer (b)

We have said to industry that if, as an outcome of our surveillance activity, conflicts of interest, for example, are not being managed appropriately, we will take regulatory action and if necessary, revisit the need to suggest law reform in relation to this sector.

Research providers must hold an AFSL and comply with the general licensing obligations including those relating to the management of conflicts of interest and other obligations relating to the provision of general advice, and a range of prohibitions, including those against misleading and deceptive conduct, dishonest conduct and insider trading, for example.

Our policy settings in RG 79 update the regulatory framework and are designed to improve the production of research and to increase the sophistication of retail and wholesale clients in their level of reliance on research reports. In releasing our updated guidance for research providers, we clearly communicated our expectation that research providers needed to 'lift their game'.

Question 16

Financial planners pay research houses for the time and expertise that is involved in producing a research report into a fund or product.

(a) To what extent does ASIC then expect a financial planner to undertake their own critical evaluation of a research report and what does ASIC think this should involve?

Answer

Regulatory Guide 175 Licensing: Financial product advisers—Conduct and disclosure RG 175.314 - 317 sets out our guidance for advice providers using research reports. We expect advice providers to make inquiries and research the products they give advice on. Where they use research, we expect them to conduct due diligence on research report providers that they intend to use and our updated guidance in RG 79 will help them to do this. We consider the due diligence will need to consider the business model, conflicts of interest associated with that service provider, how it selects products for rating, the methodology it employs and its spread of ratings. This will help the advice provider to form a view about the service provider and the extent to which the adviser can rely on the research. Regardless of their use of third party service providers such as research providers, the advice provider remains responsible to the client for the advice they give.

Question 17

In its submission to the Trio inquiry, the Financial Planning Association (FPA) noted a conflict between the commercial interest of some licensees and the best interests of a financial planner's clients. The FPA recommended a statutory best interest duty 'for the consumer as a whole' to apply to all licensees and not just those dealing directly with retail clients.

(a) Could ASIC comment on this proposal?

(b) Does ASIC have any concerns that even after the FOFA reforms concerning 'client best interest' and 'conflicted remuneration' are in place, that when a financial institution creates financial products and also controls a financial advice network, the situation could still arise where the sales target of the financial institution conflicts with the financial adviser's best interest obligation to their client?

Answer (a)

Under the Corporations Act, licensees must do all things necessary to ensure that the financial services covered by their license are provided efficiently, honestly and fairly. Licensees are also subject to obligations under the ASIC Act including: implied

warranties as to due care and skill and fitness for purpose. The desirability of law reform to impose further or more explicit obligations on product manufacturers to take account of the needs of consumers as a whole is a matter for Government.

Answer (b)

Section 961J requires that if a provider knows, or reasonably ought to know, that there is a conflict between the interests of the client and the interests of the provider or an associate or representative, the provider must give priority to the client's interests when giving advice. This obligation applies to advisers working for an advice network that is controlled by a financial institution. Regulatory Guide 175 states that in order to comply with this obligation, an advice provider must not over service clients to generate more remuneration for themselves or related parties where the level of service is not commensurate with the client's needs.

Question 18

In its submission to the Trio inquiry, the Financial Planning Association (FPA) welcomed the 'best interest duty' and the banning of commissions under the FOFA reforms. However, the FPA noted that product reform is not being addressed, including in the area of potentially misleading claims being made about products.

(a) Is ASIC considering ways to enhance the responsibility of product providers and fund managers in developing products for retail investors?; and if so,

(b) What consultation has ASIC undertaken in this area, what has been the industry response, and is ASIC considering anything more than appealing to the best interests of product providers and fund managers?

Answer

Answer not yet supplied.

Question 19

Does ASIC have an expectation that a custodian would communicate with an auditor when preparing net asset value calculations for an RE?

Answer

See below.

Question 20

Given that the requirements faced by a custodian appear to be primarily around the holding of sufficient assets, to what extent does ASIC view custodians as critical gatekeepers in the system as compared to the role played by auditors, research houses and trustees?

Answers to question 19 and 20

A custodian may or may not be engaged to prepare net asset value calculation for an RE. If a custodian does undertake an engagement to prepare net asset valuations, the custodian would not routinely consult with an auditor, whether the auditor of the RE, of the managed investment scheme or of the compliance plan for the managed investment scheme, in performing such calculations. On the other hand in performing an audit, an auditor may seek information from the custodian concerning the assets held, and the systems that the custodian uses to hold assets and in performing any calculation functions where it is relevant to the subject matter of the relevant audit.

In ASIC Report 291 ASIC stated that 'We consider custodians to be gatekeepers within the financial services industry, with responsibility in the product chain for the safe keeping of client assets'. It is not possible to assess whether a custodian is more or less 'critical' compared with auditors, research houses and even trustees or responsible entities - they all have a significant but distinct role to play. Custodians play an important operational role in the day-to-day activities of the finance industry and in keeping assets in custody. They are generally only engaged to act on authorised instructions of the RE. The role of a custodian does not include any investment management or other discretionary decision making powers in relation to those assets.

Question 21

What checks would ASIC expect a trustee to undertake to ensure that the data being incorporated into the net asset valuation calculations by a custodian are robust and correct and how would this work in practice?

Answer

In the context of portfolio holdings disclosure, it is the trustee that needs to be confident that the information they are disclosing on their website is accurate and does not contain misleading statements. The trustee needs to undertake whatever checks it considers appropriate to be satisfied that the information it obtains from its custodian is accurate.

In a superannuation context, APRA has some oversight of trustees and their relationship with material outsourced service providers, which may include custodians. For example, APRA may scrutinise the level of review that the trustee engages in with its service providers.

We note that as a result of Stronger Super reforms and changes to reserve requirements, an increasing number of trustees may opt not to have a custodian at all.

Question 22

Could you explain what you aim to achieve with consultation paper No. 204 into the risk management systems of responsible entities?

Answer

Currently, under the Australian financial services licence regime, licensees including responsible entities (REs) are required to comply with a general requirement to ‘maintain adequate risk management systems unless the licensee is regulated by APRA’ (s912A(1)(h) of the Corporations Act (the Act)).

Consultation paper 204 Risk management systems of responsible entities (CP 204) outlines our proposals to strengthen risk management systems in a way that fleshes out what is adequate and what is good practice in a more applied context and aims to help REs to better identify and manage the risks they face in the operation of schemes including strategic, governance, operational, investment and liquidity risks.

We propose these changes in CP 204 on the basis of the findings from ASIC's 2011–12 review of the risk management systems of a selected group of REs. The review found that the risk management systems vary significantly in sophistication with REs. For example, we have concerns that the non-APRA-regulated REs tended to have less comprehensive and sophisticated risk management systems.

CP 204 proposed to enhance the general risk management obligation in s912A(1)(h) by way of a class order to subject REs to targeted requirements in relation to their risk management systems, supported by industry specific guidance for the managed funds sector to supplement our existing guidance in Regulatory Guide 104 Licensing: Meeting the general obligations. The consultation ended in May 2013. Responses received were generally supportive of the proposals in CP 204. ASIC is in the process of finalising the proposed class order and regulatory guidance.

BT Financial Group: answers to questions taken on notice 21 June 2013, received 12 July 2013

Question 1

The FOFA reforms place a statutory onus on financial planners and advisers to put the best interests of their clients first and to avoid conflicted remuneration. However, there is a concern that when a financial institution creates financial products and also controls a financial advice network, a situation could still arise where the commercial interests of the licensee conflicts with the financial adviser's best interest obligation to their client.

Answer

BT Financial Group is the wealth management arm of the Westpac Group and in addition to other bodies is regulated by the Australian Prudential Regulatory Authority (APRA) and the Australian Securities and Investment Commission (ASIC).

BT Financial Group takes its responsibilities as a gatekeeper and a financial services provider seriously.

We place customers at the centre of everything we do, which includes acting in their best interests when providing financial advice.

As part of the recent Future of Financial Advice (FOFA) reforms, which we support, we have implemented new 'best interests' requirements to further support planners in demonstrating they have met their best interests obligations to customers.

We have strong and well-established risk management and governance frameworks. These establish clear protocols for how we operate as a business, including the products we offer to our customers whether through our Approved Product Lists or otherwise. We accept that conflicts of interest may arise from time to time in the normal course of business. However, we are confident that we have appropriate processes and protocols in place for managing any such conflicts.

In addition:

- Our advisers are not restricted to recommending our products, and they can and do advise on and recommend other products to our customers.
- We are continually improving our products to ensure they meet the needs of our customers.
- We have strong controls in place to ensure that our advisers only recommend products when it is in the best interests of our customers. Our advisers are required to place customer interests above their own and above those of the

BT Financial Group and the Westpac Group, and there are consequences for our advisers if they do not do this.

Question 1(a)

The committee understands that BT Financial Group makes financial products and also employs advisers to sell those products. Can you comment on whether BT Financial Group's financial planners and financial advisers are subject to sales targets, and if so, could this create tension for your financial advisers in meeting the best interests of their clients?

Answer

We do not employ advisers to sell products. We employ advisers to provide financial advice and to help meet the financial needs of our customers.

We believe in the value of financial advice and we provide quality advice to customers in a strong and sustainable model.

We do not impose product sales targets on any of our financial advisers.

In the adviser channels we own (i.e. Securitor and BT Select) we work with financial adviser practices by helping them to attract and service customers but we do not specify sales or revenue targets for these practices or their financial advisers.

The salaried adviser channels (e.g. Westpac Financial Planning and St.George Financial Planning) have revenue targets, and planners participate in a bonus scheme. All revenue (initial and ongoing), and all asset categories or products (i.e. managed funds, direct equities, etc.), are treated equally under this scheme. Salaried advisers are only eligible to participate in the bonus scheme if they have met certain requirements within a particular period (including feedback from customers and meeting compliance requirements). There are no sales targets relating to particular products, Westpac Group products or asset classes.

We take our responsibilities seriously in supporting quality advice to customers. We require planners and management to comply with the law as well as applicable regulations and company policies. In particular, we require our planners to comply with best interest obligations and consequences of failing to comply are serious and can include withholding or cancelling a planner’s bonus, performance management and, potentially, termination. We carry out regular auditing of planners. We also assess and review our obligations, key controls, including our monitoring system, at least annually.

Question 1(b)

Does BT Financial Group take any responsibility for managing the conflict of interest that may exist for its financial advisers between the 'best interest' duty to their clients and a perceived or real need for the financial advisers to promote the financial products of the Group within which they work?

Answer

We accept that conflicts of interest may arise from time to time in the normal course of business. However, we are confident that we have appropriate processes and protocols in place for managing any such conflicts.

Specifically, we take our responsibility for both the construction of the Approved Product List (APL) and providing an appropriate framework for meeting best interests requirements extremely seriously.

Our Advice business' internal research team follows robust processes and established protocols to create APLs to ensure customers gain access to quality products. These protocols include an ongoing benchmarking process to compare products against peers in the market to determine their suitability for inclusion on the list. Members of the research team are not incentivised to recommend that any particular product or asset class be placed on an APL. These research criteria, including the benchmarking process, is applied consistently to all products whether internally or externally sourced. All decisions on APLs are made independent of product issuers, and the decision-making process has appropriate controls and oversight.

Planners are ultimately responsible for determining what products are appropriate for their customers' circumstances. We support our planners in order to meet this obligation, and have trained the planners to understand our process to establish the APL and their responsibilities to ensure they have separately considered any product they are considering recommending in light of the customers' needs and objectives.

Through our internal research team, clear guidance is provided to support our planners on what products may or may not be appropriate for particular needs and circumstances. We do not impose product sales targets on any of our financial advisers.

Planners are required to place customers interests first and in priority to their own or those of the organisation. We will continue to embed the FOFA driven changes through continued training, support, monitoring and testing.

Any failure to demonstrate compliance with the best interests obligations will result in significant consequences under our policies, which can include withholding or

cancelling a planner's bonus, performance management and, potentially termination. In addition, planners may be subject to additional controls including increased monitoring and supervision, mandated para-planning and vetting.

Question 1(c)

If BT Financial Group does not rely solely on the financial adviser complying with the new FOFA reforms, what protocols does BT Financial Group have in place to avoid or manage this conflict should it arise?

Answer

We provide support in order to assist the planner in meeting these obligations, including through robust processes in order to set the APLs and other policies, training and monitoring activities. The planner is ultimately responsible for complying with the new best interests FOFA reforms as discussed above.

We have a number of protocols in place. These include:

- conduct and behavioural standards incorporated into employment contracts, and performance and reward schemes;
- strong and well-established risk and governance framework;
- well-developed, robust and regular assessment of licensee and general obligations and the control effectiveness in ensuring compliance;
- a strong risk culture predicated on the three lines of defence strategy independently assessed as effective with a high degree of management alignment;
- embedded compliance objectives in management Job Descriptions and 'Scorecards' with defined measures;
- a range of practical controls to ensure the right planners are recruited, planners are adequately trained and accredited (beyond current industry requirements), supervised and monitored. This is further supported by a range of policies and consequences framework where standards are not adhered to; and
- a range of tools, systems and reports that support planners, and management in managing against new, and existing obligations in the provision of advice.

Question 2

Does BT Financial Group have an internal research house function? If so, can you comment on the cost of high quality qualitative research from research houses relative to the cost of BT Financial Group conducting the same quality of research in-house?

Answer

BT Financial Group is supported by two key in-house research teams, focusing on Advice and Fund Manager Governance.

(a) Advice

The Advice in-house research team is responsible for the review of investments to formulate an Approved Products List which provides guidance to financial planners when providing advice to customers.

The team undertakes a formal research process to identify best of breed investment opportunities across all asset classes and product types. Investments are reviewed and monitored on a regular basis. We note that the in-house research team is required to assess internally and externally sourced products in the same way in its research assessment.

The Advice in-house research teams have access to external research resources including Zenith Investment Partners, Chant West, JP Morgan, Bloomberg and Morningstar as inputs into the research process.

For the Advice business, external research is also used to supplement broader investment choice for our external adviser networks.

(b) Fund Manager Governance

The Fund Manager Governance in-house research team is responsible for monitoring and oversight of all investments across our platform, superannuation and investment businesses.

The team provides analysis and recommendations in relation to selecting investment options and appointing fund managers, as well as oversight and monitoring of investment options, for the platforms, superannuation and investment businesses.

As well as undertaking its own due diligence on investment managers, the team has access to external research resources including Lonsec, Zenith Investment Partners, Chant West, van Eyk and Morningstar as inputs into the research process.

One of the key functions of both in-house research teams is to support the delivery of quality outcomes to clients. We believe an in-house research function allows greater

support that is tailored to the needs of our financial planning network and allows better oversight of the quality of the research conducted.

Question 3

Is BT Financial Group a dual regulated entity offering both Responsible Entity and Registrable Superannuation Entity services? Are there advantages in being licensed to act as a Responsible Entity and as a Registered Superannuation Trustee, and if so, what are they?

Answer

BT Financial Group is a holding company and is not a regulated entity. However, there are some entities within its group that are dual regulated entities operating as a Responsible Entity (RE) of a number of managed investment schemes and as a Registrable Superannuation Entity (RSE) licensee, as trustee of a number of public offer superannuation funds.

An RE and RSE licensee are both trustees with statutory and fiduciary duties to hold and invest assets for the benefit of beneficiaries. While there are some differences between the duties of an RE and RSE, they are not as significant as their similarities. The Stronger Super reforms that have amended the duties of RSE licensees and their directors are very closely modelled on those that apply to REs.

By combining the roles of RE and RSE licensee in a single company and Board, the beneficiaries of the company's managed investment schemes and superannuation funds benefit from:

- the specialist expertise of trustee directors appointed for their relevant knowledge and skills;
- risk management and conflicts management systems directed to the roles and duties of trustees; and
- specialist advisers including in-house counsel, who specialise in advising trustees.

Question 4

Given that a compliance plan auditor is only required to ascertain the compliance of a Responsible Entity with its compliance plan, could you clarify for the committee who is actually responsible for ensuring that a Responsible Entity adheres to the constitution of the Responsible Entity's managed investment scheme?

Answer

The compliance plan of a registered scheme must set out adequate measures that the responsible entity is to apply in operating the scheme to ensure compliance with the Corporations Act and the scheme's constitution.

The Board of a Responsible Entity is responsible for ensuring that the scheme's constitution is complied with. BT Financial Group's compliance and governance framework is designed to assist the Boards of each company that acts as an RE to oversee the company's compliance with all of its legal obligations, including complying with the terms of a scheme's constitution.

Question 5

A paper just published in the Journal of Economic Perspectives by veteran American economist, Burton G. Malkiel,[1] indicates that over the last 30 years, passively-held index funds have substantially out-performed the average active fund manager. He also observes that the amount of under-performance is well approximated by the difference in the fees charged by the two types of funds. Mr Malkiel acknowledges that some active management is required for market efficiency because it ensures that information is properly reflected in securities prices. However, he found that 'the number of active managers and the costs they impose far exceed what is required to make our stock markets reasonably efficient.

(a) Can you comment on the rationale for the higher fees for asset management charged by fund managers when the evidence gathered by Malkiel for the last three decades indicates that a passive investment would have brought greater returns for the investor?

Answer

What is 'active management'?

Active portfolio management is the process of applying research and skill in order to deliver superior results over an index based passive exposure. Investment managers that apply an active strategy will tend to charge a higher fee than passively managed strategies but the true measure of success is the return generated for clients after taking into account the fees charged.

Active management can be considered at the asset allocation level as well as at the sector level. Setting strategic asset allocations for an extended period and having

1 Burton G. Malkiel, Asset management fees and the growth of finance, Journal of Economic Perspectives, Vol. 27, No. 2, Spring 2013, pp 97–108.

strategies passively rebalance does not take into account the ever changing nature of markets and investor behaviour. Active management at this level is synonymous to risk management and is imperative to maximising the probability of meeting return objectives for investors over the medium and longer term.

At a sector level, in many markets, the degree of overall alpha (excess return above a benchmark) available to all managers and investors will tend toward zero over time. But there will always be winners and losers and the success of a variety of strategies will vary greatly according to the market environment, risk appetite and return drivers over the period being measured. In Australian equities over the last 10 years, 1st quartile managers have delivered more than 1.2% above the index after taking fees into account (Mercers data to end May 2013).

Active management can increase returns

It is our view that an active approach can enhance risk adjusted returns. Alpha opportunities exist as markets are not always efficient, and this provides the potential for pricing anomalies which can be exploited. Skilful managers can extract alpha even after their costs are deducted. Some managers have unique insight and can exploit opportunities in different market conditions. Our approach identifies these managers and invests with them, employing a disciplined and repeatable process through qualitative manager research. We also change managers to suit the forecast market conditions.

An active approach can support a higher return objective for long term investors than a passive approach would allow. Their investments can be evaluated against an absolute return target, expressed as a return of a certain level over inflation (or 'CPI+'). Over time, a passive strategy will require a higher degree of market risk for longer in order to achieve the same result as a well-managed active strategy.

Economies go through cycles that favour different investment approaches at different times. Active management allows the risks associated with these cycles to be mitigated while the opportunities presented by these cycles can be exploited. Different investing styles (such as 'value' or 'growth' investing within equities) add value at different times and an active strategy can tilt a portfolio in favour of an outperforming style. A passive approach does not allow for this.

Active management can mitigate risks

In a GFC-like event, a passive approach will not engage in downside risk management which can lead to a higher degree of capital erosion. In fact, passive strategies that follow an index will tend to invest in the companies that go bankrupt and in the bonds that will default.

Past performance over the last 10 or 30 years is not necessarily indicative of future trends and outcomes. There is no guarantee that the investing environment is the same, and indeed there are indications that we may currently be going into a different environment. Passive investing cannot provide the downside risk management that is only possible with active management.

Investments need to be managed through the cycle and this can be achieved using active asset allocation. This involves tilting a portfolio by holding more in asset classes likely to outperform and holding less in asset classes likely to underperform. Our process reflects our long-term views on asset classes in our Strategic Asset Allocation (SAA). Risks to this view from volatility and turbulence are then mitigated through our medium-term Dynamic Asset Allocation (DAA) and our short-term Tactical Asset Allocation (TAA).

Passive management has its own issues

There are problems with passive management and viewing this approach as a 'base case' or starting position for investment is flawed. Most benchmarks that are tracked in a passive strategy are weighted by market capitalisation. This means that more of the portfolio is held in securities that are worth more, while less of the portfolio is held in securities that are worth less. This is somewhat arbitrary and is not necessarily an appropriate basis for structuring a portfolio.

The main issue with using market capitalisation as the only source of information is that as a price of a security relative to others increases, the passive approach will invest more in that stock. This effectively embeds a momentum process into the stock selection, emphasising past winners in the portfolio and ignoring value opportunities. It equates to buying stocks after they have become more expensive and selling them after they have become cheaper.

Modern portfolio theory suggests that once targeted returns are reached, gains should be crystallised through the sale of outperforming assets. This is not possible with a passive approach, where in fact the opposite occurs. When tracking a market capitalisation-weighted index, investors are forced to hold more of stocks that have increased in value and less of stocks that have decreased in value.

It is also our view that market capitalisation is not the only relevant measure of the future return generating capacity of a stock. A passive process assumes stock prices are always a reflection of true value. It ignores diversification across sectors and size and can lead to undiversified portfolios of assets. Additionally, the composition of indices changes over time. This introduces risks to the portfolio that could otherwise be addressed through active management.

Finally, a passive approach cannot consider the outcomes required by the investor. For example, in the S&P/ASX 200, there is presently a large overweight tilt to bank stocks. A passive investor will therefore have a corresponding large overweight allocation to this sector. This is a risk that passive investing cannot address.

Case study – Standish Mellon International Fixed Interest

We have invested in Standish Mellon's International Fixed Interest strategy since October 2005, providing almost 10 years of data and offering an observable outcome of active management over a passive benchmark. Since inception to May 2013, the Standish mandate has returned 10.24% net (after fees) annualised while the Barclays Global Aggregate (Hedged to AUD) has returned 7.69%. The active approach has outperformed by 2.55% annualised over this period. This outperformance is significant and justifies taking an active approach.

During this time, the bond market has gone through significant shifts, and by employing an active approach Standish has been able to accommodate these shifts, mitigate the risks and add alpha to the fund. A passive approach through this environment has not been able to deliver the same outcomes.

Investment theory and technical considerations

A passive investment strategy seeks only to earn the benchmark or market return, known as beta. An active investment strategy receives the same beta, plus the excess return of the manager, known as alpha. By definition, alpha is uncorrelated to beta. This means that the outperformance or underperformance of a manager does not depend on whether the overall market is going up or down. This makes alpha a valuable and efficient source of return.

By examining risk-adjusted returns using an Information Ratio, it can be demonstrated that an active approach can deliver higher returns per unit of risk than a passive approach. Looking at a Sortino ratio can show similar information and additionally identify the downside protection offered by a strategy.

'The Fundamental Law of Active Management', developed by Grinold and Kahn, states that a manager's information ratio is a function of the information coefficient and the breadth of investments. This means that the risk-adjusted returns that a manager delivers above a benchmark can be explained by the manager's level of skill and the number of investment decisions it makes. In other words, to achieve a good result, an active manager needs to be good at picking stocks and also ensure the portfolio is appropriately diversified.